

Reforming Uganda's Small Business Tax

Report prepared for the Uganda Revenue Authority

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Table of Contents

EXECUTIVE SUMMARY	1
POLICY RESEARCH QUESTION.....	3
BACKGROUND	3
The Client.....	3
Defining the Target Population.....	5
THE CURRENT TAX ENVIRONMENT	6
Income Tax.....	7
Withholding Tax.....	8
VAT	10
Small Business Tax.....	10
Accounting and Record Keeping Requirements for All Taxpayers	12
Income Tax and VAT Performance.....	13
UGANDA’S SMALL BUSINESS CLIMATE.....	14
Characteristics of Difficult to Identify Taxpayers.....	14
Tax Noncompliance.....	15
EVIDENCE FOR EVASION.....	17
Record Keeping	18
Small Business Tax Revenue Performance	19
OBJECTIVES OF A SMALL BUSINESS TAX.....	20
Enhanced Competition.....	20
Reduced Cost of Compliance.....	21
Increase Revenue.....	21
POLICY OPTIONS	21
Eligibility	22
Patent Systems	22
Advantages	22
Disadvantages.....	22
Description of Application	23
Presumptive Taxation Based on Turnover or Gross Proceeds	23
Advantages	23
Disadvantages.....	23
Description of Application	24
Presumptive Systems Based on Indicators.....	25
Advantages	25
Disadvantages.....	25
Description of Application	26
Presumptive Taxation Based on a Combination of Turnover & Indicator-Based Systems .	26
Description of Application	26
Net Cash Flow.....	26
Advantages	26
Disadvantages.....	27
Description of Application	27
POLICY ELEMENTS OF A SMALL BUSINESS TAX	27
Definition of Small Business	27
Qualification on Activities	27
Bookkeeping Requirement	27
Registration.....	28
Definition of Employee.....	28
Related Parties.....	28

Activity Splitting.....	28
Optional Registration.....	28
Exempt Taxes.....	28
Graduating from Presumptive into Standard Tax System.....	28
Threshold Issue.....	29
CRITIQUE OF EXISTING SYSTEM RELATIVE TO THE OBJECTIVES & POLICY OPTIONS	29
RECOMMENDATIONS FOR REFORMING UGANDA’S SMALL BUSINESS TAX	31
Eligibility	31
Tax Base	33
Tax Rate	35
Tax Credits.....	36
Provisional Tax.....	36
In Lieu of Taxation.....	36
Employee	37
Other Matters	37
Transition Rules	37
Audit Rules.....	38
Taxpayer Services.....	38
Appendix 1: Results from World Bank Enterprise Surveys	39
Appendix 2: Comparison of Small Business Tax Regimes in Latin America & Africa	40
Appendix 3: Small Business Tax Regimes Around the World	43
Appendix 4: Examples of Computing Net Cash Flow	44
Appendix 5: Example of Small Business Tax Form Based on Net Cash Flow.....	49
Appendix 6: Guidelines for Determining Employee Status	50
BIBLIOGRAPHY	53

EXECUTIVE SUMMARY

Topic & Relevance

There are many small and medium size businesses operating outside the modern sector in Uganda that meet statutory thresholds for paying taxes but either fail to do so, or fail to pay their full tax liability. Capturing a larger proportion of the tax that should otherwise be paid can help Uganda increase the provision of public goods, provide enhanced public services such as education, reduce the government's dependence on foreign aid, which was approximately 25% of government revenue in 2010 and reduce the budget deficit.¹ This report seeks to increase tax compliance among Ugandan taxpayers operating small and medium sized business by providing specific recommendations to the Uganda Revenue Authority (URA) for reforming the current small business tax system.

The Current Small Business Tax Regime

Businesses with gross annual turnover between Shs. 5 million and Shs. 50 million qualify for the small business tax (there are some exclusions), which serves as a final tax on the business income of the taxpayer. One of the primary advantages of a turnover-based small business tax is that it allows small and medium sized businesses to avoid many of the fixed and variable costs associated with keeping proper books of account. However, Uganda's current Income Tax Law negates this advantage by requiring all taxpayers to follow generally accepted accounting principles.

Taxpayers under the small business tax regime face significantly smaller tax burdens than they would under the corporate or personal income tax, thereby creating incentives for taxpayers to remain in the small business tax regime or underreport turnover in order to qualify for small business taxation. In addition to creating perverse incentives, Uganda's current small business tax fails to meet the three objectives of a small business tax system: enhance competition, reduce cost of compliance and increase revenue.

Recommendations

I recommend Uganda amend their current small business tax regime and utilize net cash flow as the small business tax base. Using net cash flow as the small business tax base will reduce the distortions in the current turnover-based regime and allow Uganda to maintain statutory record keeping requirements. Switching to a system with net cash flow as the base will not be a radical transformation for Uganda's taxpayers or the URA. Many small business taxpayers are already keeping books of account, likely on a cash basis. Furthermore, the Income Tax Act currently allows taxpayers to account on a cash or accrual basis, unless otherwise specified by the Commissioner General.

Switching to a net cash flow based small business tax necessitates a number of other changes to the small business tax regime. I am proposing several abuse of ownership

¹ Syda N. M. Bbumba, "Budget Speech Financial Year 2010/11" (Parliament of Uganda, Uganda Ministry of Finance, Thursday, June 10, 2010).

rules designed to prevent tax evasion and tax avoidance among larger firms capable of paying the standard profits tax. I am also excluding from the small business tax regime any resident physical person or entity whose aggregate receipts from all economic activities exceeds the VAT threshold.

The tax rate under the new small business tax regime will be 30% and any taxpayer who becomes eligible for a different taxation regime will change regimes only at the beginning of the next tax year. To ease the transition to either the corporate profits tax or personal income tax, the tax liability during the first year under a new status will be equal to 50% of the total liability computed by reference to the taxpayer's prior status and 50% of the total liability computed by reference to the taxpayer's new status.

Policy Research Question

What should the Uganda Revenue Authority (URA) do to increase compliance for taxpayers operating small and medium sized business?

Background

The Client

The client is the Uganda Revenue Authority (URA). The URA was established in 1991 “with the responsibility to collect and assess tax revenues, and to advise government on policy issues relating to revenues.”² A five-member board governs the URA, with board members appointed by the Minister of Finance to three year terms. The Commissioner General of the URA serves on the board as well as one representative of the Ministry of Finance, one representative of the Ministry of Trade and Industry, one representative of Uganda Manufacturers Association and the Minister of Finance may also appoint up to two, non-public officers – same as non-government employees – to serve on the board. The Commissioner General (CG) heads the management of the URA. Reporting directly to the CG are six commissioners, each one in charge of their own department including: Corporate Services Department, Legal Services and Board Affairs Department, Internal Audit and Compliance Department, Tax Investigation Department, Domestic Taxes Department, and Customs Department.

Tax policy in Uganda is made in the Tax Policy Department within the Ministry of Finance Planning and Economic Development (MFPED). The proposals developed in this department are submitted for parliamentary consideration. In Uganda, the Speaker of Parliament is from the ruling NRM party and the MFPED is staffed primarily by NRM members.³ In addition, the leader of the party, President Yoweri Museveni, has been in power since 1986. Considering the power of the President and his party, tax policy in Uganda is susceptible to influence by the executive. The executive’s influence is limited by the government’s desire to adhere to best practices – “current tax policies have been closely intertwined with current international development assistance trends.”⁴ The URA frequently interacts with the Tax Policy Department and interactions include tax policy discussions. In recent years, very few policy proposals have been submitted to parliament due to an effort by the government to maintain consistency in the tax code.⁵

Since the URA’s inception in 1991, government tax revenue has increased significantly (chart 1 displays nominal growth in net URA tax collections). However, tax revenue collection in Uganda is lower than the average for Sub-Sahara Africa (20% of GDP) and

² Jalia Kangave, "Improving Tax Administration: A Case Study of the Uganda Revenue Authority," *Journal of African Law* 49, no. 2 (2005), 150.

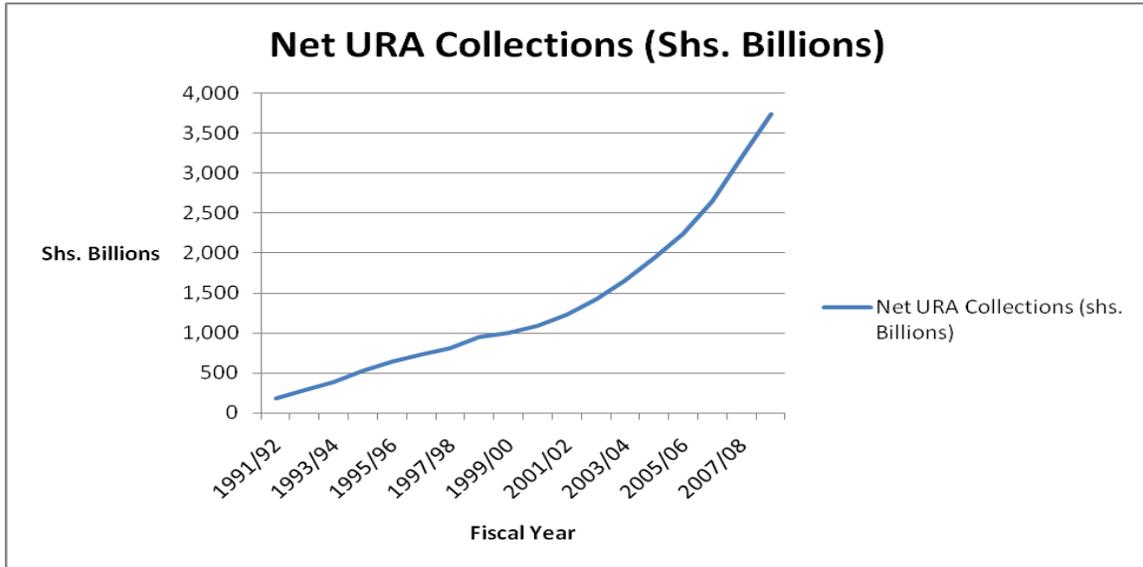
³ *Uganda's Taxation Policy: Implications for Poverty Reduction and Economic Growth* (: Uganda Debt Network, 2008), 34.

⁴ *ibid.* 35

⁵ Ronald Nyenje, Anonymous, 2010.

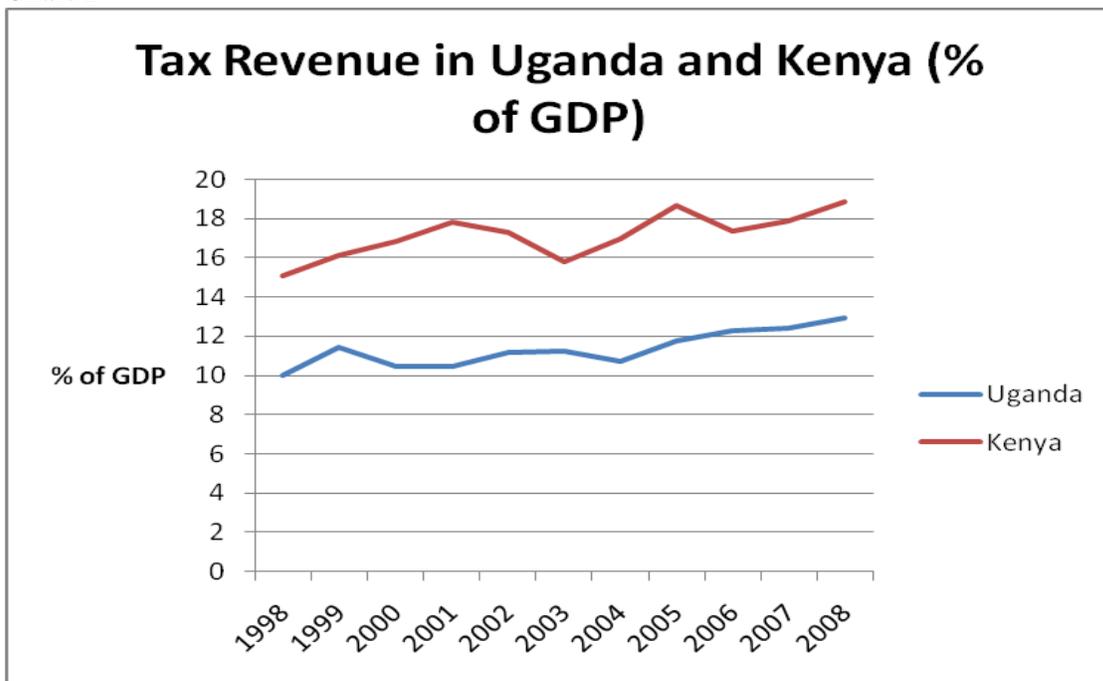
Uganda's tax revenue collection has consistently lagged behind that of its neighbor to the east, Kenya (See Chart 2). Furthermore, for approximately the first five years after the URA's inception, nominal tax revenue increased at a greater percentage rate than nominal GDP but has since tapered off to grow at essentially the same rate as GDP (see Chart 3).

Chart 1



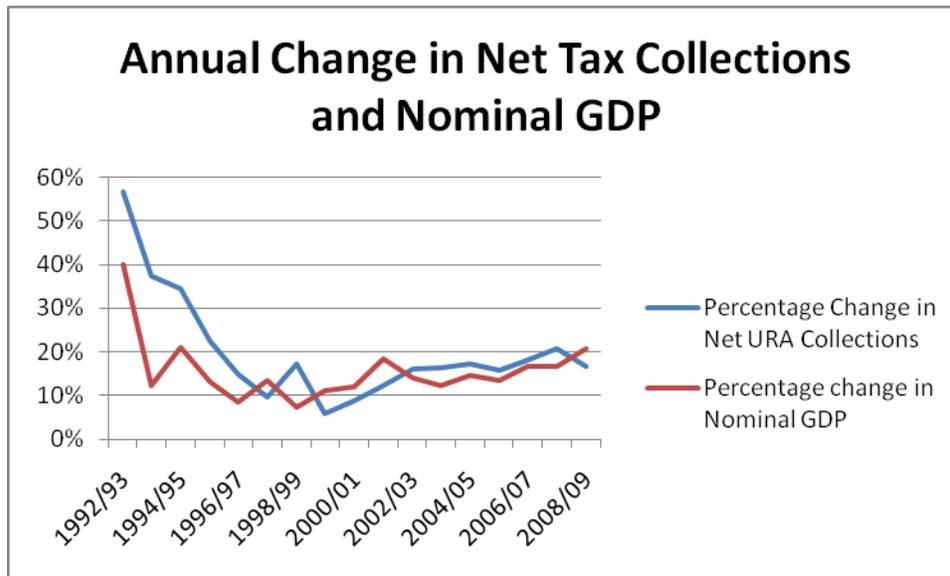
Data provided by the URA

Chart 2⁶



⁶ This data includes taxes that are not collected by the Kenya Revenue Authority and Uganda Revenue Authority

Chart 3



Data provided by the URA

Defining the Target Population

Uganda has a significant population that operates outside the modern sector. The modern sector, for my purposes, is characterized by transactions based on legally binding formal agreements, access to formal capital markets and reporting to tax and regulatory authorities – all three of these conditions must be met to qualify as operating in the modern sector. Operating outside the modern sector does not imply that persons are either poor, uneducated or tax exempt. There are many small and medium size businesses operating outside the modern sector in Uganda that meet statutory thresholds for paying taxes but fail to do so, or fail to pay their full tax liability. Capturing a larger proportion of the tax that should otherwise be paid can help Uganda increase the provision of public goods, provide enhanced public services such as education, reduce the government’s dependence on foreign aid, which was approximately 25% of government revenue in 2010 and reduce the budget deficit.⁷

“The informal economy” is the term frequently used to describe the portion of the economy operating outside the modern sector. David Schneider estimates that the informal economy in Uganda could produce as much as 43.1% of GDP⁸, of which 24% is likely to be smallholder agriculture.⁹ Precisely defining the informal economy is difficult. In 2002, the International Labor Organization defined the informal economy as “all economic activities by workers and economic units that are – in law or in practice –

⁷ Syda N. M. Bbumba, "Budget Speech Financial Year 2010/11" (Parliament of Uganda, Uganda Ministry of Finance, Thursday, June 10, 2010).

⁸ Friedrich Schneider, "Size and Measurement of the Informal Economy in 110 Countries Around the World," (2002), 6.

⁹ The estimate of 24% for smallholder agriculture’s contribution to the informal sector is based off of agriculture, forestry, and fishing’s contribution to official GDP

not covered or insufficiently covered by formal arrangements”¹⁰. Such definitions are too general for present purposes. I am less concerned with whether an organization is defined to operate in formal or informal markets than I am with organizations that should be registered taxpayers but are not, and their reasons for noncompliance. Three potential groups might be indentified to facilitate the design of well targeted policy solutions:

- Individuals or entities that should be paying taxes but don’t know that they are required to file and pay
- Individuals or entities that should be paying taxes but either avoid URA detection or underreport tax liabilities
- Individuals or entities that should not be taxed

The first classification is comprised mainly of small businesses operating on a cash basis, meaning that goods or services are paid for in cash or in kind, and receipts are typically not provided. Proprietors and managers of these businesses generally do not keep proper records, may have little formal education and have limited knowledge about the tax system.

The second group consists of “ghosts,” being those who by choice operate off the fiscal radar, and “icebergs,” entities who only reveal a portion of their economic activity to tax authorities. This classification can include large corporations not resident in Uganda but that have Ugandan source income and either pay no or few taxes on this income. Entities in this classification may be engaged in illegal business activity, other than tax evasion, such as selling drugs or smuggling goods. Entities may choose to be “ghosts” or “icebergs” because tax rates are too high or the cost of compliance is too burdensome. Businesses in this classification may not maintain proper records because they wish to avoid paying taxes, they don’t know they are required to maintain records or they don’t know how to keep records.

The final group is comprised of organizations below statutory thresholds for either registration or filing.

This report is concerned with increasing compliance from the first two classifications.

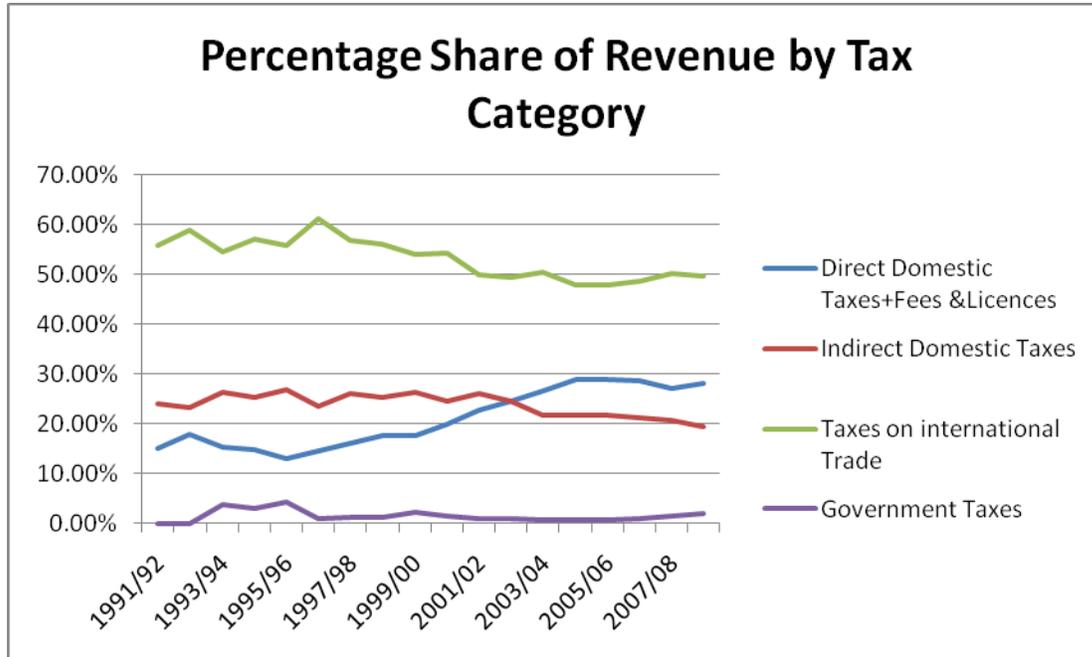
The Current Tax Environment

Historically, international trade taxes, including VAT on imports, have generated the majority of tax revenue in Uganda (see Chart 4). International trade taxes, as a percentage of revenue, have been trending downward over the last fifteen years, in part due to a reduction in import duties leading up to the East African Community Customs Union coming into effect in 2005. The downward trend in international trade taxes is expected to continue, albeit at a slower rate, as Uganda implements reforms

¹⁰ Ralph Hussmanns, "Measuring the Informal Economy: From Employment in the Informal Sector to Informal Employment," (2004), 2.

commensurate with the East Africa Common Market which came into force on July 1, 2010. The remainder of tax revenue collection in Uganda comes primarily from direct and indirect taxes. Direct taxes are comprised of the various taxes contained in the income tax act. Indirect taxes are comprised of the Value-Added-Tax (VAT) and excise duties. Since the URA's inception in 1991, revenue from direct taxes has increasingly become a greater share of total revenue while the revenue share of indirect taxes has been gradually declining.

Chart 4



Data provided by the URA

Income Tax

Income tax is imposed on the world wide income of taxable persons resident in Uganda and Ugandan source income of those not resident. Rates for resident individuals are summarized in Table 1 and non-resident individuals in Table 2.

Table 1 Income Tax Rates for Resident Individuals¹⁶

Chargeable Income	Rate of Tax
Not exceeding Shs. 1,560,000 ¹⁷	Nil
Shs. 1,560,000 - Shs. 2,820,000	10% of the amount by which chargeable income exceeds Shs. 1,560,000
Shs. 2,820,000 - Shs. 4,920,000	Shs. 126,000 plus 20% of the amount by which chargeable income exceeds Shs. 2,820,000
Exceeding Shs. 4,920,000	Shs. 546,000 plus 30% of the amount by which chargeable income exceeds Shs. 4,920,000

Table 2 Income Tax Rates for Non-Resident Individuals¹⁸

Chargeable Income	Rate of Tax
Not exceeding Shs. 2,820,000	10%
Shs. 2,820,000 - Shs. 4,920,000	Shs. 282,000 plus 20% of the amount by which chargeable income exceeds Shs. 2,820,000
Exceeding Shs. 4,920,000	Shs. 702,000 plus 30% of the amount by which chargeable income exceeds Shs. 4,920,000

The income tax rate for companies, other than mining companies, is 30%. The income tax rate for mining companies is determined according to the following formula: $70 - (1500/X)$, where X is the number of percentage points for the ratio of chargeable income of the mining company for the year of income to the gross revenue of the company for that year.¹⁹

Withholding Tax

Withholding tax is a form of income tax that is deducted at source by a payor to another taxable person. Withholding tax is used in three broad categories: employment income, gross payments/earnings other than employment earnings, and imports.

¹⁶ Uganda Revenue Authority, *Domestic Tax Laws*, 2009).

¹⁷ As of November 6, 2010 One Uganda Shilling (Shs.) was worth 0.00044 U.S. dollars

¹⁸ *ibid.*

¹⁹ *ibid.*

Pay-as-you-earn (PAYE) is a withholding tax on employment income. The employer is required to deduct the proper amount of tax from the employee's monthly employment income and remit the tax to the URA. The tax rates for PAYE are the same as above, with monthly income below Shs. 130,000 (1,560,000/12) exempt from tax.

Withholding tax is also applied to interest earnings, dividends and professional fees. A resident person who pays interest to another resident person is required to withhold 15% of the gross payment amount. Interest withholding tax does not apply to:

- a. Interest paid by a natural person
- b. Interest, other than interest from government securities, paid to a financial institution
- c. Interest paid by a company to another company if one of the companies controls fifty percent or more of the voting power in the other company
- d. Interest paid which is exempt from tax in the hands of the recipient

The law requires that a resident company which pays a dividend to a resident shareholder shall withhold tax equal to 15% of the gross payment. If the company making payments is listed in the Uganda Securities Exchange, the rate is 10%.

Any time a government agency purchases goods or materials, or any service, in excess of one million shillings, 6% of the amount shall be withheld. All persons who import goods into Uganda are liable to pay 6% as well on the value of imported goods at the time of importation. The import tax withheld is then credited against the taxpayer's final income tax liability.

A resident person who pays management or professional fees to a resident professional is required to withhold 6% of the gross amount.

The law requires all withholding agents to furnish a tax credit certificate to each payee every year indicating the amount of payments made and the tax withheld during the year of income. Payees who are required to furnish a return of income at the end of the tax year are granted a tax credit equal to the tax withheld from payments for the year of income in which the payments are made.

The following persons are authorized to withhold tax in Uganda:

- The Government of Uganda
- A Government Institution
- A local authority
- Any company controlled by the Government of Uganda
- Any person designated in a notice issued by the Minister
- Any person making a payment to a non-resident person
- Any promoter, agent or similar person paying remuneration to a non-resident
- A resident person (other than a natural person) who pays interest to another person

A resident company which pays a dividend to a resident shareholder
A resident person who pays management or professional fees to a resident professional

If a resident person enters into an agreement with a non-resident to provide services that will generate income sourced in Uganda, the resident person must notify the Commissioner General in writing of the nature of the agreement. The Commissioner General may then determine that the resident individual should withhold tax from any payment made under the agreement at a rate specified by the Commissioner.²⁰

VAT

The URA requires any person²¹ who in the course of conducting a commercial enterprise exceeds, or is likely to exceed, Shs. 12.5 million - which is equivalent to \$5,500 - in gross sales over three consecutive months to register for VAT. Note that the VAT threshold is consistent with the upper threshold of the small business tax although the tax laws do not contain language that explicitly links the two thresholds. VAT is imposed on business transactions involving supplies of goods and services, as well as on imports.²² A taxable person under VAT can be an individual, firm, or company. There are two rates for VAT; the standard rate of 18% and the zero rate of 0%. The Value Added Tax Act specifies exempt supplies but not exempt taxpayers. The following supplies are exempt from VAT: financial services, insurance, medical, dental, nursing services, passenger transportation services (other than tour and travel operators) and the supply of petroleum fuels, educational services, computers and hotel accommodation outside Kampala district. For zero rated supplies, the supplier charges a VAT of 0% and the supplier is eligible to recover any VAT paid on purchases used in producing that particular supply or service. Exempt supplies do not qualify for a refund of the input tax. The Commissioner General may refuse to register any person for VAT for a variety of reasons including: no fixed place of abode or business, does not keep proper records and has no bank account.²³

Small Business Tax

The income tax act contains a provision for a small business tax, a tax that serves as an “in lieu of” the normal tax regime. Under the tax law, a taxpayer “means any “person” who derives an amount subject to tax under this Act.”²⁴ The tax law defines a person as “an individual, a partnership, a trust, a company, a retirement fund, a government, a political subdivision of government, and a listed institution.”²⁵ A business is considered

²⁰ *ibid.* 106

²¹ The term any person for purposes of VAT registration includes: sole proprietor, company, partnership, estate of the deceased, trust, incorporated or unincorporated body, and club or association.

²² VAT is payable on supplies which are made: in Uganda, by a taxable person, in the course or furtherance of a business, and are not exempted.

²³ Other reasons the Commissioner General may refuse to register any person for VAT include: person has previously been registered for VAT purposes but failed to perform his duties under the VAT law, and the person is not fit and proper to be registered.

²⁴ Uganda Revenue Authority, *Domestic Tax Laws*, 2009), 16.

²⁵ *ibid.*, 14

a small business taxpayer if the business has gross annual turnover of over Shs. 5 million but not exceeding Shs. 50 million (equivalent to \$2,200 to \$22,000).²⁶

Persons engaged in the following activities cannot claim small business status: medical practice, dental practice, architectural service, engineering service, accounting practices, legal practice, any other professional service, public entertainment service, public utility service and constructions service. The small business tax rates are:

Table 3 Small Business Income Tax Rates²⁷

Gross Turnover	Tax
Where the gross turnover of the taxpayer exceeds Shs. 5 million but does not exceed Shs. 20 million per annum	Shs. 100,000
Shs. 20 million - Shs. 30 million per year	Shs. 250,000 or 1% of gross turnover, whichever is the lower
Shs. 30 million - Shs. 40 million per year	Shs. 350,000 or 1% of gross turnover, whichever is the lower
Shs. 40million - Shs. 50 million per year	Shs. 450,000 or 1% of gross turnover, whichever is the lower

The income tax act defines “gross turnover” as “the amounts shown in the recognized accounts of the taxpayer as the gross proceeds derived in carrying on a business or businesses during the year of income, including the gross proceeds arising from the disposal of trading stock, without deduction for expenditures or losses incurred in deriving that amount; and the amount, if any, shown in the recognized accounts of the taxpayer as the amount by which the sum of the gains derived by the taxpayer during the year of income from the disposal of business assets, other than trading stock, exceeds the losses incurred by the taxpayer during the year in respect of the disposal of such assets.”²⁸

The small business tax is a final tax on the business income of the taxpayer; small businesses are not allowed to take deductions for expenditures or losses incurred in the production of the business income. Small business taxpayers are not allowed tax credits except credits “for withholding tax paid in respect of amounts included in the gross turnover of the taxpayer.”²⁹ A small business may have parts of gross turnover withheld due to the sale of goods and services to the government, the provision of professional services, or the provision of other items specified in part XIII of the Income Tax Act.³⁰ Businesses may choose to opt out of the small business taxpayer classification by notifying the URA Commissioner General in writing.³¹ If the request is granted, the business will be assessed under the standard income tax regime.

²⁶ Currently 1 U.S. dollar trades for 2,400 Ugandan Shillings

²⁷ Uganda Revenue Authority, *Domestic Tax Laws*, 2009), 131.

²⁸ *ibid.*, 12

²⁹ *ibid.*, 131

³⁰ *ibid.*, 102

³¹ *ibid.*, 19

Small business taxpayers are required to pay provisional tax because small business income is not subject to withholding tax at source. Provisional taxpayers, other than individuals, are required to pay two installments of provisional tax on or before the last day of the sixth and twelfth months of the year. An individual provisional taxpayer pays four installments. The amount of each installment of provisional tax is determined according to the following formula:

$$(50\% \times A) - B$$

Where-

A is the estimated tax payable by the provisional taxpayer for the year of income; and

B is the amount of any tax withheld under the Income Tax Act, prior to the due date for payment of the installment, from any amounts derived by the taxpayer during the year of income which will be included in the gross income of the taxpayer for that year.³²

Every small business provisional taxpayer is required to furnish to the URA an estimate of their gross turnover for each year and a statement of the actual gross turnover of the taxpayer for the previous year. Any tax paid by withholding, installments, or otherwise in excess of the tax liability assessed to or due by the taxpayer for that year will be applied first, to any other tax liability due from the taxpayers and then be used to make provisional tax payments during the year of income in which the refund is to be made. Any remainder is refunded to the taxpayer.³³

Accounting and Record Keeping Requirements for All Taxpayers

The tax code states that all taxpayers should conform to generally accepted accounting principles. The tax code allows taxpayers to account on a cash or accrual basis, unless prescribed otherwise by the Commissioner. Taxpayers are required to furnish a return of income no later than six months after year's end. For taxpayers conducting business³⁴, they must include with their tax return a statement of income and expenditure and a statement of assets and liabilities. If the Commissioner is not satisfied with a return of income, the Commissioner reserves the right to make an assessment of the chargeable income of a taxpayer and the tax payable on it.

The tax code stipulates that taxpayers are required to maintain such records as may be necessary to explain the information provided in their tax return or to enable an accurate determination of the tax payable by the taxpayer.³⁵ Furthermore, taxpayers are required to retain all records of evidence for tax purposes for five years after the year of income to which the record or evidence relates. In order to enforce the Income Tax Act, the

³² *ibid.*, 98

³³ *ibid.*, 100

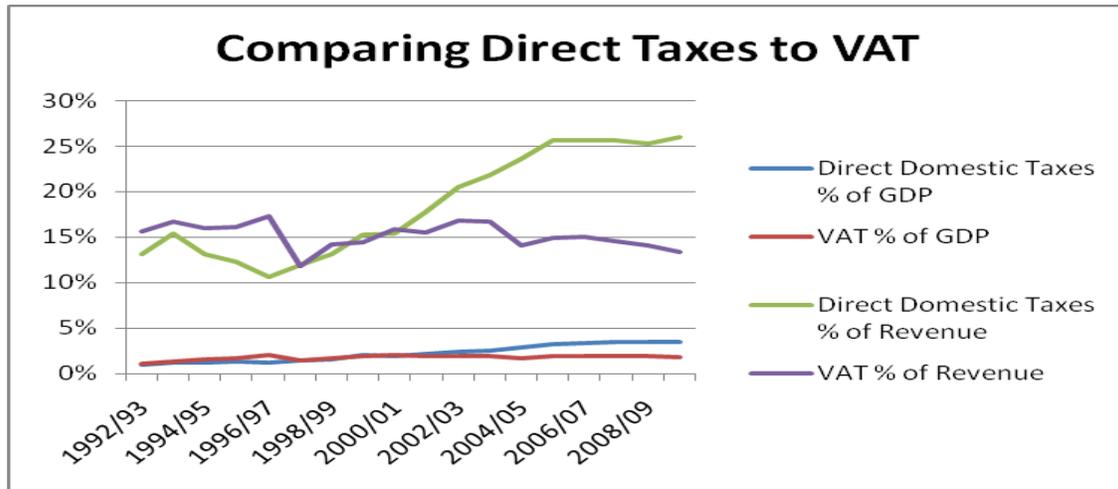
³⁴ The Income Tax Act defines business as any trade, profession, vocation, or adventure in the nature of trade, but does not include employment.

³⁵ Uganda Revenue Authority, *Domestic Tax Laws*, 2009), 108.

Commissioner, or any officer authorized by the Commissioner, has the right to access any premises, place, book, record, or computer at all times and without prior notice.³⁶

Income Tax and VAT Performance

Chart 5



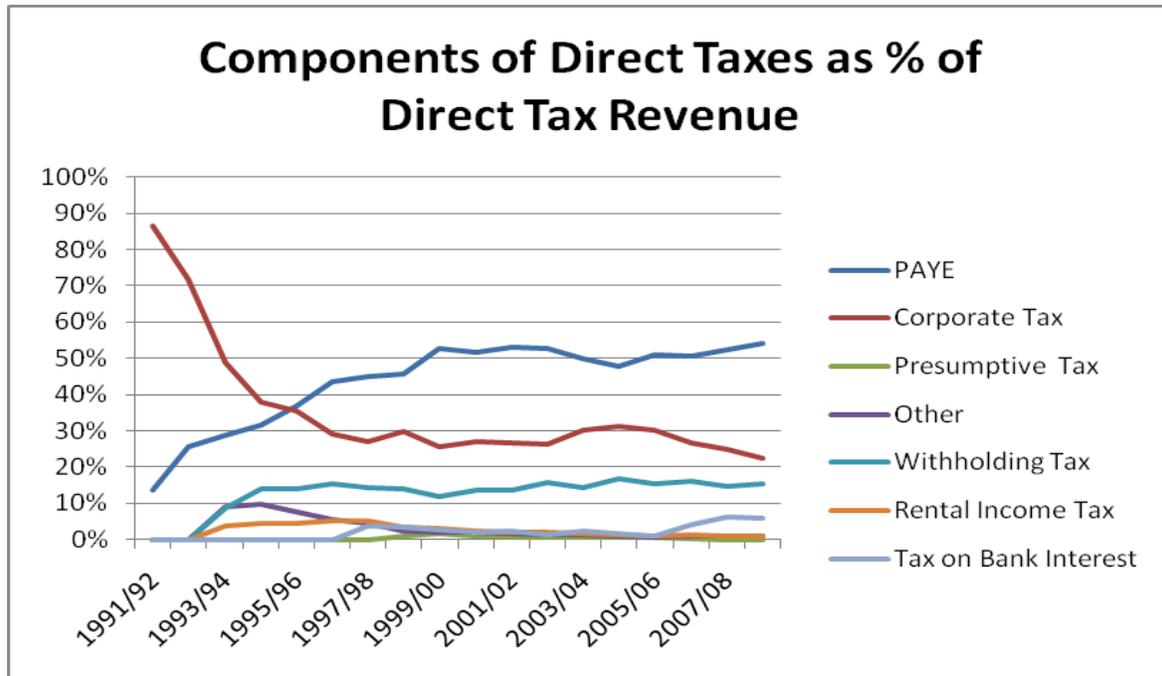
Data provided by the URA

Chart 5 displays revenue from direct taxes and revenue from VAT as a percentage of nominal GDP and as a percentage of total tax revenue. Direct taxes consist of taxes specified under the Income Tax Act: PAYE, Corporate tax, presumptive tax (same as small business tax), withholding tax, rental income tax, tax on bank interest, casino and lottery tax and agricultural products tax. Revenue from VAT, as a percentage of nominal GDP, has remained fairly constant but as a percentage of total tax revenue VAT has been much more volatile and trending downward over the last several years. Direct tax revenue has been slowly increasing as a percentage of nominal GDP but as a percentage of total tax revenue direct tax revenue has increased rapidly from just over 10% in 1996/97 to over 25% in 2008/09.

Chart 6 reveals that the increase in direct tax revenue can be attributed to the growth in revenue from PAYE. In the 1991/92 fiscal year, PAYE revenue accounted for just 14% of all direct tax revenue, a percentage that increased to 54% in the 2007/08 fiscal year. The significant growth in PAYE revenue along with steady improvement in revenue generated from withholding taxes has helped offset the decline in corporate tax revenue. In fiscal year 1991/92 corporate tax revenue accounted for 86% of all direct tax revenue but in 2007/08 it accounted for just 22% of direct tax revenue. Note that in the chart 6, presumptive tax is referring to small business tax revenue. Small business tax revenue performance is discussed later.

³⁶ *ibid.*, 109

Chart 6



Data provided by the URA

Uganda's Small Business Climate

Characteristics of Difficult to Identify Taxpayers

The Uganda Revenue Authority's report titled "Taxation of the Informal Sector in Uganda" is my primary source document. The report begins by listing characteristics that difficult to identify taxpayers might share.

1. Use of a high proportion of unskilled labor
2. Lack of formal education
3. Inadequate or no record keeping
4. Lack of organization and formal contracts

Uganda has several factors, shared by many developing countries, that contribute to a large informal sector and makes it difficult to identify potential taxpayers. Structural adjustment policies by the IMF led to a reduction in the public service from 350,000 to 200,000 by 2000 with "little or no pre-post layoff support including counseling, retraining and redeployment programs that would have helped laid off workers reintegrate into the labor market."³⁷ Civil war in Northern Uganda has led to many

³⁷ *Uganda's Taxation Policy: Implications for Poverty Reduction and Economic Growth*, 8.

people fleeing from rural to urban areas and joining the informal sector. HIV/AIDS has increased the number of orphans who in turn find work in the informal sector to provide for themselves because the minimum age for work in Uganda is 14. And finally, a steady flow of rural to urban migration in search of paid employment.³⁸

Data confirms the existence of a significant informal sector in Uganda. According to the World Bank's Enterprise Surveys for Uganda from 2006, 73% of small businesses in the service sector reported that they were competing against unregistered or informal firms and 35.3% of all firms surveyed identified the practices of their competitors in the informal sector as a major constraint.³⁹ And as stated earlier, David Schneider estimates that the informal economy in Uganda could produce as much as 43.1% of GDP⁴⁰, of which 24% is likely to be smallholder agriculture.⁴¹

Tax Noncompliance

Organizations in any country may choose to operate in the informal sector and therefore be tax noncompliant for several reasons; two of the primary reasons are complicated/restrictive rules and regulations and high tax rates. Complicated or restrictive rules and regulations increase a business's cost and can even prevent business formation. Table 4 compares business start-up costs between Tanzania, Kenya, and Uganda. The table reveals that business start-up costs – measured as percent of Gross National Income per capita – are considerably higher in Uganda than in Kenya and Tanzania and that the number of procedures required to register a business is higher in Uganda as well. These two factors impose constraints on new business formation in Uganda and provide an incentive for firms to remain in the informal sector.

Table 4 Comparison of Business Start-Up Costs in Uganda, Tanzania, and Kenya⁴²

	Uganda	Kenya	Tanzania
Cost of business start-up procedures (% of GNI per capita)	84.4	36.5	36.8
Time required to start a business (days)	25	34	29
Start-up procedures to register a business (number)	18	12	12

The World Bank's Enterprise Surveys provide hundreds of business environment indicators by conducting face-to-face surveys of business owners and top managers. The most recent surveys for Uganda were conducted in 2006 and the data can be broken down by firm size, with size determined by number of employees – 5-19 (small), 20-99 (medium), and 100+ employees (large). The Enterprise Surveys provide further evidence of excessive tax compliance cost within Uganda (see appendix 1 for pertinent results).

³⁸ Francis Abibi Odongo and Banyendera Hannington, *Taxation of the Informal Sector in Uganda* (: Uganda Revenue Authority, 2006), 7.

³⁹ "Enterprise Surveys," The World Bank, <http://www.enterprisesurveys.org/>

⁴⁰ Friedrich Schneider, "Size and Measurement of the Informal Economy in 110 Countries Around the World," (2002), 6.

⁴¹ The estimate of 24% for smallholder agriculture's contribution to the informal sector is based off of agriculture, forestry, and fishing's contribution to official GDP

⁴² World Bank's World Development Indicators database

According to the data, senior managers in Uganda spend 5.21% of their time dealing with government regulations, with managers at smaller firms spending more time dealing with government regulations than their counterparts at medium and large firms. Meeting with tax officials increases tax compliance costs and small businesses average 2.27 visits per year with URA officials, compared to 2.62 for medium sized businesses and 2.83 for large businesses. Corruption is a significant cost of doing business in Uganda; 14.53% of all firms surveyed expected they would have to give gifts in meetings with tax officials – large firms were more likely to give gifts than small and medium-sized businesses.

Relatively high tax rates are another determinant of informal sector activity and tax noncompliance. Although most businesses don't like paying taxes, the Enterprise Surveys data reveals that Uganda's business community, particularly small businesses, considers high tax rates a major constraint on their operations. Small businesses (67.66%) were far more likely than large businesses (36.31%) to consider tax rates a major constraint on their current operations. Small businesses were also more likely to consider tax rates a major constraint than their counterparts in other Sub-Saharan African (37.77%) and low-income (37.32%) countries (see chart7). Tax rates are considered so problematic within Uganda's business community that when asked what was the top constraint businesses were faced with, tax rates came in second, behind only electricity (see chart 8).

Chart 7

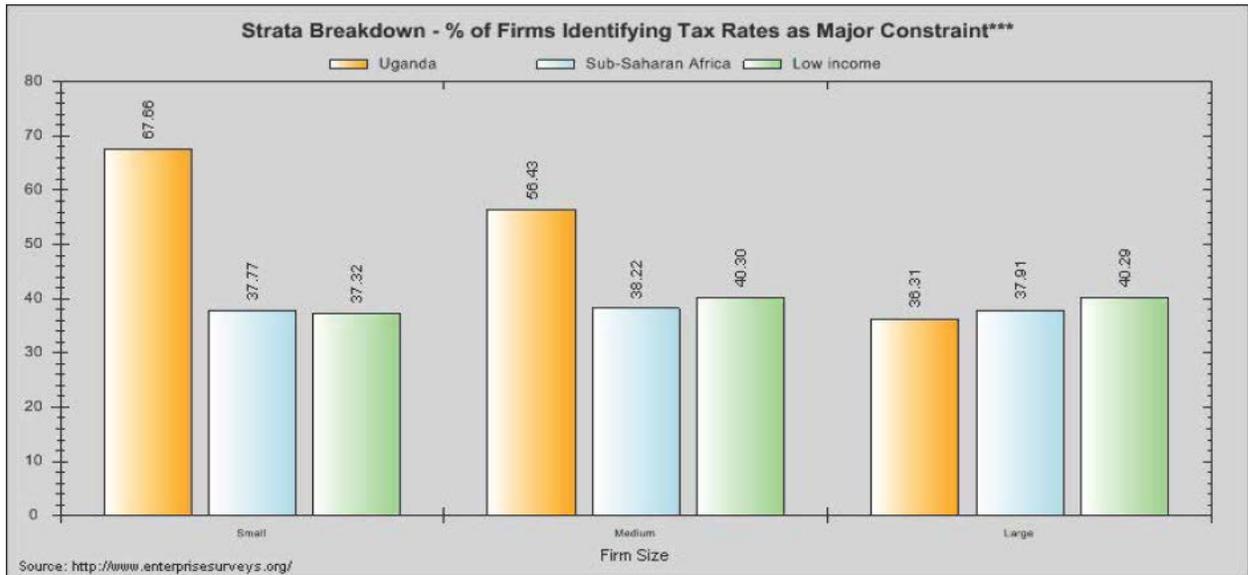
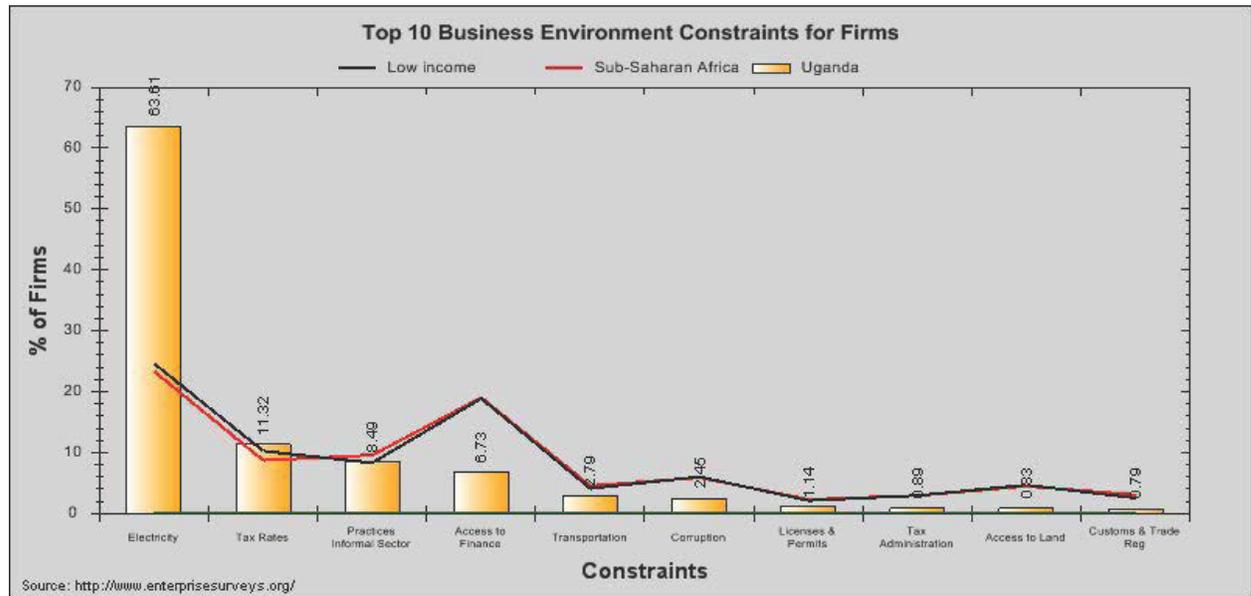


Chart 8



Evidence for Evasion

Bernard Gautier and Ritva Reinikka, in a paper titled “Shifting Tax Burdens through Exemptions and Evasion” provide a detailed, although dated, picture of tax evasion in Uganda. Gautier and Reinikka use survey data collected from The World Bank and the Ugandan Private Sector Foundation, who surveyed 243 firms in 1998 regarding their activities in 1995 and 1997. The survey included questions on physical investment, exports, infrastructure services, taxation, policy credibility, regulation and corruption.⁴³ A stratified random sample was used to interview firms in 5 geographical areas representing 5 different industries: manufacturing, agro processing, commercial agriculture, tourism and construction. Gautier and Reinikka’s main findings were that tax evasion was most prevalent among smaller firms, larger firms were more likely to receive tax exemptions and medium sized firms bore a disproportionate share of the total tax burden.

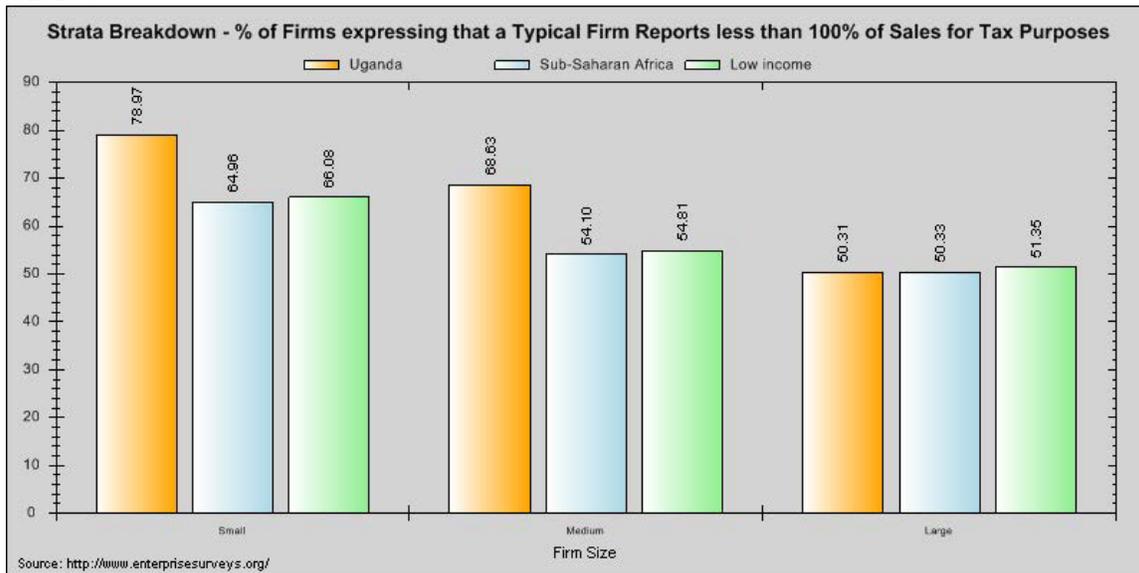
The authors defined tax evasion as any firm that reported not paying a specific tax or group of taxes and reported no full exemptions. The survey asked firms about three main business taxes: corporate income tax (CIT), sales tax and value added tax, and the national social security fund levy (NSSF). Of the 158 firms for which information on tax payment and exemptions were available in 1995, seventy-three (46%) evaded at least one of the three taxes; with the least evaded tax being the CIT (28%) and the most evaded tax the NSSF (35%). There was a small decline in tax evasion in 1997 with 44% of firms

⁴³ Bernard Gauthier and Ritva Reinikka, "Shifting Tax Burdens through Exemptions and Evasion: An Empirical Investigation of Uganda," (2001), 5.

evading at least one tax. The NSSF was still the most evaded tax with 29% of firms evading and the VAT was the least evaded at 9%. The authors surmise that the decline in VAT and CIT evasion is due to the introduction in 1997 of a minimum VAT threshold of 50 million shillings and also the introduction of a small business tax. Gautier and Reinikka also examine the impact that tax exemptions and tax evasion have on effective tax burdens, as measured by the amount paid for the three main domestic taxes divided by sales values. In 1995, firms with 2 to 5 employees faced an effective tax burden of 3%. Firms with 26 to 75 employees faced an effective tax burden of 7% and firms with over 200 employees had an effective tax burden of 2% - this same inverted U-shaped trend was also found in 1997. The data revealed that smaller firms tended to reduce their tax liability through evasion while larger firms primarily reduced their tax liability through the use of exemptions, principally the CIT exemption.

The Enterprise Surveys provide some more recent insight into the prevalence of tax evasion in Uganda. In 2006, nearly 79% of small businesses reported less than 100% of sales for tax purposes. This compares to 68.63% for medium-sized businesses and 50.31% for large businesses. Chart 9 reveals that small and medium sized businesses in Uganda were more likely than small and medium sized businesses in other Sub-Saharan African and low-income countries to underreport their sales for tax purposes.

Chart 9



Record Keeping

Gautier and Reinikka’s paper and the World Bank’s Enterprise Surveys also detail the prevalence of recordkeeping within Uganda’s business community. Gautier and Reinikka found that 91% of firms surveyed kept accounts. Broken down by firm size, 38% of firms with less than 6 employees kept books, 89% of firms with between 6 and 76 employees kept books and all firms with more than 76 employees kept books. Ninety-four percent of the firms that did not keep accounts were tax evaders – as defined

previously – and 13% of firms evading all three taxes did not keep accounts. The Enterprise Surveys do not ask firms directly if they keep records but they do ask firms if they have their annual financial reports reviewed by an external auditor. Every large firm surveyed had their annual financial statements reviewed by a third party auditor, but only 71.47% of medium sized firms and 37.43% of small firms had their annual financial statements reviewed by a third-party auditor.

Small Business Tax Revenue Performance

In the URA’s internal accounts the small business tax revenue is referred to as presumptive tax revenue; charts 10 and 11 below detail presumptive tax revenue. Chart 10 shows that revenue from the small business tax hit its peak in fiscal year 2005/06 when it totaled 3.67 billion shillings. After this peak, revenue from the small business tax declined precipitously and in fiscal year 2008/09 – the latest year available – revenue from the small business tax was 270 million shillings – the lowest it’s ever been. During this period of decline, it’s possible that some taxpayers in the small business regime transitioned into the standard regime, in which case revenue from the small business tax would fall in absolute terms and as a percent of total tax revenue. I am skeptical of this possibility due to the strong incentives taxpayers have to remain in the small business regime, which I will detail later. Even during the period when small business tax revenue was gradually increasing, from 2000/1 to 2004/5, it was still not keeping pace with growth in total tax revenue because as a share of total tax revenue small business tax revenue was declining. It is clear from chart 10 that revenue from the small business tax has historically been very small, peaking at 0.28% of total tax revenue and 0.03% of GDP in 1999/00. As a general rule, tax revenue increases as GDP increases, however chart 11 indicates that revenue from Uganda’s small business tax appears to be unrelated to changes in GDP.

Chart 10

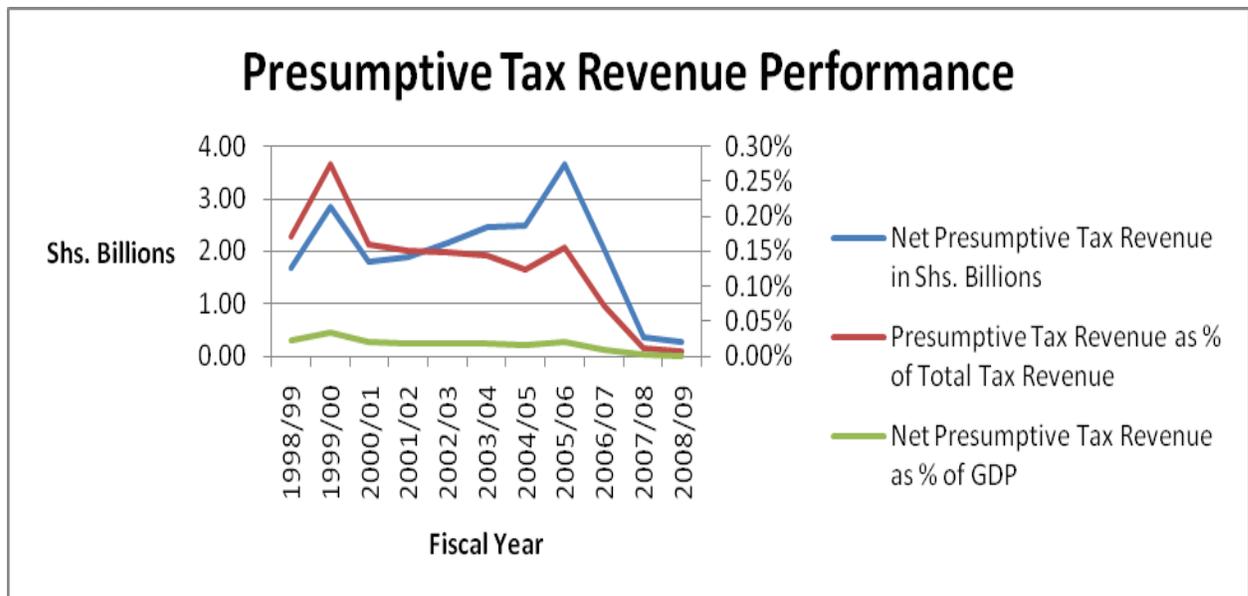
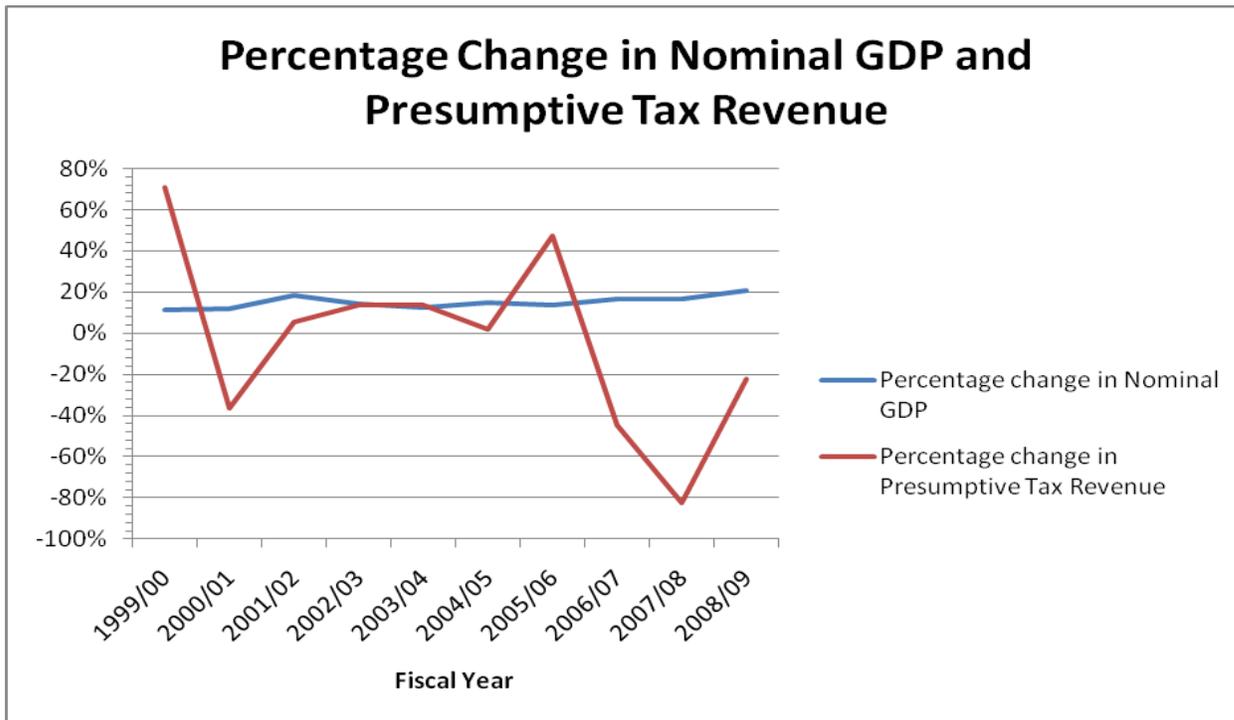


Chart 11



Objectives of a Small Business Tax

Enhanced Competition

The record keeping requirements of standard profits tax often put small businesses at a competitive disadvantage due to the fixed and variable costs of maintaining records. “Fixed costs include developing and understanding financial and record keeping systems necessary to comply with the tax laws. Variable costs include the costs of keeping records on a current basis, keeping apprised of changes in the rules, audit costs and maintenance of records for significant time periods.”⁴⁴ Small business tax regimes can allow small businesses to avoid many of the fixed and variable costs associated with standard profits tax.

Tax incentives create another competitive disadvantage for small businesses. Incentives such as accelerated depreciation, tax holidays, special zones and other incentives often require businesses to have significant taxable income to qualify, thus favoring larger businesses over smaller ones. Tax incentives add another layer of complexity to the tax system and small businesses typically don't have the resources necessary to determine if they apply for the incentive or the resources required to administer the incentive.

⁴⁴ Robert Conrad and Mike Alexeve, "Small Business Taxation" (Memo,) 5.

Reduced Cost of Compliance

A well designed small business tax may draw small businesses into the formal sector by lowering the cost of compliance. Compliance costs include monetary and non-monetary elements. Small businesses in Uganda may face a variety of compliance costs, including: “the costs of acquiring sufficient knowledge to meet legal requirements; of compiling the necessary receipts and other data; making the relevant calculations and completing tax returns; paying professional advisors for tax advice; paying incidental costs of postage, telephone, and travel to communicate with tax advisors or the tax office; collecting, remitting, and accounting for tax on the profits of the business, and on the wages of employees.”⁴⁵ By simplifying recordkeeping requirements, small business taxes can significantly lower compliance costs which may entice more small businesses to enter into the tax system and broaden the tax base. A broader tax base is perceived as more fair by those who are currently in the tax system and may further increase voluntary tax compliance.

Increase Revenue

Small business tax systems generally do not generate much revenue. Their true value lies in their ability to create or enhance a taxpaying culture and facilitate the movement of businesses from the small business tax regime to the standard regime. Well designed small business tax systems can give taxpayers experience in recordkeeping that will benefit them “in the sense that they will have records sufficient to enter the formal capital market, obtain financing via transparent methods and become more integrated into the formal economy.”⁴⁶ Greater access to transparent financing and integration into the formal economy can allow small businesses to become medium-sized businesses and potentially – large businesses. As these businesses grow they will pay more in taxes; thus an effective small business tax regime can increase tax revenue in the future by facilitating flow into the standard tax regime.

Policy Options

I examine different methods that might be used to tax small businesses (see appendix 2 for a comparison between small business tax regimes in Latin America and Africa). A description of each method is provided along with the advantages and disadvantages of each method followed by an example, or examples, of the method in use (see appendix 3 for a table of various small business tax systems around the world). Five different small business tax systems are analyzed:

1. Patent systems

⁴⁵ Michael Engelschalk et al., *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners* (: International Finance Corporation, 2007), 11.

⁴⁶ Robert Conrad and Mike Alexeve, "Small Business Taxation" (Memo,) 5.

2. Presumptive taxation based on turnover or gross income
3. Presumptive taxation based on indicators
4. Presumptive taxation based on a combination of turnover and indicator-based systems
5. Net cash flow

Eligibility

The first step in designing any of the five small business tax regimes listed above is determining who is eligible for the regime. The most common criterion, and the one favored by the IMF, is turnover. The IMF focuses primarily on VAT when assessing a country's tax system and they recommend that the upper threshold of the small business tax be equal to the lower threshold for VAT. Therefore, no taxpayer can simultaneously be a VAT and small business taxpayer. There are other methods of determining who qualifies for the small business tax regime, such as using asset values and number of employees. Whatever the criterion, or criteria, used to determine eligibility for the small business tax regime, it should accurately reflect a business's ability to pay tax. That is, the eligibility requirements should be set so that to every extent possible those who qualify for the small business regime are not fully capable of paying taxes under the standard regime.

Patent Systems

Patent systems apply a fixed fee per annum to various business segments; they are the simplest of small business taxation methods. "A patent system could be designed as a required minimum tax, with additional income taxes levied if income is greater than a specified threshold. Alternatively, the taxpayer might be subject to only the patent with no attempt to enforce compliance beyond the simple payment."⁴⁷

Advantages

The advantages of patent systems are that administrators are not required to estimate potential business profit as part of the tax base, there is no disincentive to grow or earn profit provided the business does not move into the standard tax regime, and businesses face a transparent and predictable tax burden.

Disadvantages

Patent systems ignore businesses ability to pay. Therefore, businesses in the same industry could face different tax burdens depending on their profits. Patent systems also tend to generate less revenue than other methods of small business taxation.

⁴⁷ Robert Conrad, "Small Business Taxation" (Memo, , 2005), 2.

Description of Application

Patent systems are common in transition countries. Bulgaria introduced a patent tax in 1998 that explicitly lists taxpayers that are liable under the system. The “Levy of a final annual (license) tax” lists 43 different small business sectors and divides the country into nine zones.⁴⁸ Furthermore, the 43 small business segments were divided into six sub-categories and divided yet again by business quality. Tax rates are determined by business activity and zone location, there are more than 300 tax rates and they are updated regularly.

Presumptive Taxation Based on Turnover or Gross Proceeds

Presumptive taxation based on turnover or gross proceeds is the most prevalent method of small business taxation. These systems do require businesses to maintain some basic books of account. To encourage taxpayers to use simplified recordkeeping some countries, like Tanzania, assess a lower tax liability on businesses that keep simplified records compared to businesses that do not. Such a system forces tax administrators to determine the turnover of businesses that do not keep records.

Advantages

Turnover-based small business tax regimes allow small businesses to avoid many of the fixed and variable costs associated with the standard profits tax. Turnover-based systems also allow tax liabilities to fall during periods of below-average volume. A small business tax can also be based on gross proceeds which is a more accurate measure of business income compared to turnover. Gross proceeds may be defined as all cash receipts excluding capital contributions and repayments.⁴⁹ Interest income and other payments are considered to be part of gross proceeds in order to prevent taxpayers from using the small business tax system as a shelter for other types of taxable income or re-characterizing sales as other types of income.

Disadvantages

Proponents of turnover-based small business tax regimes argue that such regimes create incentives for small businesses to enter the formal economy and register for taxes. But what incentive do businesses that are currently not registered and pay zero tax have to enter the small business tax regime and pay reduced taxes? This is not to say that tax evasion is costless. Small business taxpayers can gain experience in recordkeeping and these records may allow them to gain access to formal capital markets and obtain standard bank financing. Furthermore, businesses may have to pay bribes or protection money in order to evade tax. However, statistics and experience have shown that the benefits of entering a small business tax regime fail to exceed the costs of evasion.⁵⁰

⁴⁸ Engelschalk et al., *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners*

⁴⁹ Robert Conrad, "Small Business Taxation" (Memo, , 2005), 3.

⁵⁰ Conrad and Alexeve, *Small Business Taxation*, 11.

Turnover-based tax regimes that apply a uniform rate on all taxpayers pose other problems as well. They tend to favor businesses with high profit margins (low costs relative to revenue) by imposing lower effective tax rates – the effective tax rate is measured as the proportion of tax payable to inclusive profit. For instance, service industries tend to have low costs relative to their revenue, in contrast to the manufacturing sector which tends to have high costs relative to revenue. Turnover-based systems also fail to account for different profit margins within industries. For instance, two restaurants could be nearly identical except one is in an urban area and the other in a rural area. The restaurants could have the same value of turnover but the restaurant in the urban setting may have to offer its employees higher wages and pay more for rent. Due to the higher level of expenses, the urban restaurant will have lower profits but both restaurants will have the same tax liability.

In addition, a small business tax regime based on turnover provides an incentive for individuals to become contractors instead of employees because employees must pay standard income tax whereas contractors can be assessed under the small business tax regime. Turnover-based regimes can also induce firms to purchase less of all inputs in order to maximize their net of tax profits.

Description of Application

Brazil employs a turnover based regime known as SIMPLES. Businesses below annual turnover of BRL 2,400,000 qualify for the system and pay a single tax in lieu of six different federal taxes, one state tax, and one municipal tax. The applicable tax rate varies from 4% to 17.42%, depending on the type of activity. In Ethiopia, tax administrators apply a tax on turnover to all businesses with over \$5,000 in annual turnover, but the rate varies depending on your level of turnover and the business profession. This system is designed to tax businesses according to their presumed profit margins but it is administratively complex compared to a uniform rate on turnover. The Ethiopian turnover tax law lists 69 different professions and 19 turnover bands with a progressive rate, which requires setting 1,311 tax rates.⁵¹

Tanzania seeks to encourage simplified recordkeeping by assessing businesses that keep simplified records a lower tax liability than business that do not. However, experience has shown Tanzania's simplified tax system has been unsuccessful in increasing the level of recordkeeping among small businesses.⁵² Kenya seeks to minimize administrative burden while at the same time encouraging simplified recordkeeping by imposing a 3% turnover tax on all businesses that keep records and are below the VAT threshold of 5 million Shs. and applying a rate of 3% on 5 million Shs. if a business does not keep records – in effect this serves as a minimum tax

⁵¹ Engelschalk et al., *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners*, 63.

⁵² *ibid.*, 65

Presumptive Systems Based on Indicators

External indicators can be used as a proxy for income. Good indicators should meet the following criteria: they must be easy to verify and record, they must have a low risk of falsification, concealment, and substitution; and they must show a sufficient and stable correlation to actual income.⁵³ Some common indicators used throughout the world include: number of employees, floor space of business premises and value of inventory. Presumptive tax systems based on indicators are not technically an income tax. Rather they are an “in lieu” of income tax based on indicators

Advantages

Presumptive systems based on indicators hold several advantages over turnover-based systems. It is difficult to conceal the existence or size of many indicators, such as floor space of business premises, thus tax evasion is less of a problem. However, some indicators can still be concealed from authorities, such as employees or the value of inventory. Furthermore, if the indicators are easily identifiable, fewer disputes should result.

Indicator based systems do not require bookkeeping; therefore compliance costs are relatively low but business owners will still be required to make some effort to determine if they are eligible for the indicator-based system.

Disadvantages

Despite their advantages, indicator based systems are difficult to design. According to the International Finance Corporation, some of the principal design problems are⁵⁴:

- It is difficult to design indicators that sufficiently reflect profit potential or a small business owner’s ability to pay.
- The profit potential of comparable businesses with identical indicators could depend on several factors, such as location. Some countries account for additional factors but this can be administratively messy and complicated.
- Business owners and management are not required to keep adequate books, therefore they do not benefit from the insights provided by proper records if such records are not kept.
- Tax administrations must conduct extensive research on profit margins in various business segments in order to have well defined indicators and avoid ongoing disputes with small businesses.
- Indicator-based systems can have undesirable incentive effects. For example, an indicator-based system that uses the number of employees as an indicator provides an incentive for businesses to lay off staff or not register employees.
- Indicator-based systems adversely impact start-ups and businesses making negative profits.

⁵³ *ibid.*, 68

⁵⁴ *ibid.*, 70

- Indicator-based systems must establish detailed lists of businesses covered.

Description of Application

Poland uses a type of indicator based system called the “tax card” system. Tax liability is determined by the type of business activity, the number of employees and the number of inhabitants in the place of business activity.

Presumptive Taxation Based on a Combination of Turnover & Indicator-Based Systems

Presumptive taxation based on a combination of turnover and indicator-based systems is designed to counteract under declaration of gross turnover/gross receipts. These hybrid systems hold many of the advantages and disadvantages of turnover and indicator-based systems discussed previously.

Description of Application

Argentina employs such a system called the Monotributo, which assumes businesses that consume 4,000kw of electricity or which have premises of at least 35 square meters cannot have annual turnover less than \$24,000. The indicators used by the Monotributo are well defined and difficult to manipulate. However, businesses with sizeable premises will be punished during periods of low business activity. Furthermore, the system does not take into account that certain business sectors might have different levels of energy consumption than other sectors.

Net Cash Flow

The net cash flow method of taxing small businesses is an alternative to presumptive methods. The net cash flow method allows businesses that meet specified criteria to utilize simplified cash accounting to determine taxable income. The most efficient method to measure net cash flow involves immediate expensing of all asset purchases and no accruals of any kind. Loans can be treated in one of two ways. First, loan proceeds can be considered as cash in and principal and interest payments as cash out. The other option is to not count loan proceeds as cash in and not count principal and interest payments as cash out.

Advantages

Of all possible small business tax bases, net cash flow is the closest approximation to actual profit. Because of this, and the recordkeeping requirements associated with calculating net cash flow, a small business tax based on net cash flow enables a smoother transition to the normal tax regime compared to other methods of taxing small businesses. Cash flow accounting will also help small businesses gain experience and perhaps gain access to formal capital markets. Furthermore, the marginal effective tax rate under the net cash flow system is zero. I will discuss this in more detail later, but essentially for each additional unit of profit a business makes, the effective tax rate does not change.

Disadvantages

The net cash flow method is relatively administratively complex and expensive because business costs must be measured and monitored.

Description of Application

Russia's small business tax utilizes cash flow as the tax base. Small businesses are then assessed tax liability at the corporate tax rate on all cash flow in excess of zero. The small business tax is paid in lieu of VAT and income tax.

Policy Elements of a Small Business Tax

Regardless of the method used to tax small businesses, there are a number of policy elements that need to be addressed. Below is a list of critical policy elements that any small business tax system must deal with. The list is not exhaustive but serves to highlight some of the more important policy elements that must be clarified.

Definition of Small Business

Any small business tax law will have to explicitly define eligibility. In order to prevent the small business tax from becoming a tax shelter for wealthy individuals or businesses, the definition of small business for tax purposes shall not include any business that is owned by either "a large business, a group of large businesses, a wealthy individual, a group of wealthy individuals or any combination of such persons."⁵⁵

Qualification on Activities

Tax administrators must determine if legal entities are allowed to qualify for the small business tax. Several countries structure the statutory language so as to provide small business taxation for the physical person only – not the activity.

Bookkeeping Requirement

Tax administrators must determine if the small business tax system will require books of account to be maintained. If books of account are required the standard shall be high enough so that tax administrators can determine initial and continuing eligibility. If the eligibility criterion is turnover, then small business taxpayers will be required to record turnover. Tax administrators must make further determinations for the bookkeeping requirement, including whether or not to require reporting of asset values, ownership information and gross receipts.

⁵⁵ Conrad and Alexeve, *Small Business Taxation*, 6.

Registration

All small business taxpayers are required to register and they will be issued taxpayer identification numbers. Small businesses will be required to disclose their ownership structure, address, addresses of workers, type of organization and other statutory information.

Definition of Employee

Employees should not be eligible for small business taxation and the definition of employee should be included in the income tax law, not the small business tax law.

Related Parties

“The same definitions for related parties that are used for determining transfer pricing and other rules should be applied to small businesses.”⁵⁶

Activity Splitting

A policy must be developed for taxpayers that have more than one source of income. For instance, a wage earner may also have small business income.

Optional Registration

Registering for the small business tax should be optional, or by election. If the taxpayer chooses not to be taxed under the small business tax, then they will be taxed under the normal system. If the taxpayer elects to be assessed under the normal system, they should be required to remain in the normal system for a fixed duration in order to prevent businesses from coming in and out of the small business tax system.

Exempt Taxes

The law should explicitly state what other taxes small business taxpayers are exempt from. Small business taxpayers should still be required to pay property taxes and withholding taxes on behalf of employees. However, there is some uncertainty as to whether small business taxpayers should be exempt from social security tax.

Graduating from Presumptive into Standard Tax System

Perhaps the most critical element of any small business tax is developing methods to graduate taxpayers into the normal tax system. To facilitate graduation, the small business tax should be coordinated with other taxes. Businesses close to the upper threshold of the small business tax system should not face a tax burden substantially lower than businesses at the lower end of the standard tax system.⁵⁷ Richard Bird and

⁵⁶ Robert Conrad, "Small Business Taxation" (Memo, , 2005), 7.

⁵⁷ Engelschalk et al., *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners*, 78.

Sally Wallace in a 2003 paper titled “Is it Really Hard to Tax the Hard-to-Tax? The Context and Role of Presumptive Taxes” claim that most countries with presumptive systems set the tax rates lower than the normal system due to political reasons, thereby guaranteeing that those in the presumptive system will stay there indefinitely, provided it remains the lowest cost alternative. Bird and Wallace argue that any presumptive tax system needs to set the tax burden higher than it would be under the normal system in order to provide an incentive for the taxpayer to move into the normal system. Countries have experimented with several methods to induce small business taxpayers to move into the normal system, including: limiting the length of time a taxpayer is allowed in the small business tax system, requiring taxpayers to re-qualify for the small business system periodically, and offering “incentives” such as depreciation only to firms in the normal system. It is important to note that depreciation of assets is not in and of itself an incentive, but rather a necessary step in calculating profit. The tax base of a presumptive system will determine if depreciation of assets under the normal tax system will lower the taxpayer’s liability, in which case it may be considered an incentive.

Threshold Issue

One of the principal challenges in adopting a presumptive tax is the threshold issue. The threshold issue has to deal with setting the upper and lower bounds of a presumptive tax method – basically determining who will be taxed at all. The challenge for any tax administration lies in setting these thresholds for a presumptive tax regime, which in most developing countries is in lieu of the income tax and VAT. According to Bird and Wallace, “Too high an exit threshold undermines the regular tax system [same for personal exemption] and invites too many participants into the special regime. On the other hand, an entry threshold that is too low may not serve such stated goals of special regimes as reducing tax barriers to business entry.”⁵⁸ By “business entry,” I’m assuming that Bird and Wallace mean the lower threshold of a presumptive tax system should not be so low as to prevent would be entrepreneurs from starting a business, although I do not know how this threshold would be determined.

Critique of Existing System Relative to the Objectives & Policy Options

Uganda’s current small business tax regime creates economic distortions and fails to meet the primary goals of small businesses taxation. As previously stated, turnover-based small business tax regimes allow small businesses to avoid many of the fixed and variable costs associated with standard profits tax, thereby enhancing competition. But if the government is going to require all taxpayers to maintain proper books of account, then the primary benefit of a turnover-based small business tax regime is nullified. Under Uganda’s Income Tax Act, Section 40, subsection 1, a taxpayer’s method of accounting must conform to generally accepted accounting principles. Furthermore, under section 92, subsection 5 of the Income Tax Act “A taxpayer carrying on business shall furnish with the taxpayer’s return of income a statement of income and expenditure

⁵⁸ *ibid.* 19

and a statement of assets and liabilities.”⁵⁹ This requirement applies to all small business taxpayers. If the government of Uganda wishes to retain the current recordkeeping requirements in the Income Tax Act, there is no point in maintaining a turnover-based small business tax.

If a small business tax regime is unlikely to entice new businesses to enter the formal tax system than it is imperative that the regime does not incentivize taxpayers to drop from the standard tax regime into the small business tax regime, or prevent existing small business taxpayers from ever graduating out of the small business tax regime. Unfortunately, Uganda’s current small business tax regime does both. Consider a company with Shs. 50,000,000 in turnover – the upper threshold of the small business tax regime – that currently pays the small business tax. Taxpayers with turnover between Shs. 40 million and Shs. 50 million per year must pay a tax of Shs. 450,000 or 1% of gross turnover, whichever is the lower. Therefore, the company would pay Shs. 450,000 in tax. Suppose now that the company’s turnover increased to Shs. 50,000,001 and that the company has costs of Shs. 20,000,001. The company’s turnover now exceeds the upper threshold of the small business tax regime and they must now pay the corporate tax rate of 30% on profit. Taxable profit would be Shs. 30,000,000 and tax would be Shs. 9,000,000. Therefore, after switching from the small business tax regime to the standard regime the taxpayer’s tax liability increased by 1,900%. Such a large jump in tax liability provides an incentive for taxpayers to remain in the small business tax system as long as possible and encourages existing standard tax regime taxpayers to understate their turnover in order to stay in the regime.

Consider the same example as above except the taxpayer is not a company but a resident physical person operating an unincorporated business. If this taxpayer has business turnover of Shs. 50,000,000 their tax liability is still Shs. 450,000 under the small business tax regime. If this taxpayer’s business turnover increases to Shs. 50,000,001 and they have costs of 20,000,001 they must pay personal income tax on profit of Shs. 30,000,000. Under the personal income tax, the taxpayer’s liability would be Shs. 8,070,000, an increase of 1,693% from the liability under the small business tax regime.⁶⁰ Again, the taxpayer faces an incentive to remain in the small business tax regime as long as possible, or if the taxpayer is currently paying personal income tax they have an incentive to underreport turnover in order to qualify for the small business tax regime. The same perverse incentive exists for unincorporated businesses at the lower threshold for the small business tax. A physical person operating a business with Shs. 5,000,000 in turnover faces a tax liability under the small business regime of Shs. 100,000. Assume the same taxpayer has costs of Shs. 2,000,000, under the personal income tax their tax liability would be Shs. 162,000, which is 62% greater than it is under the small business tax regime.

Further evidence of the distorting nature of Uganda’s small business tax regime is the ratio of costs to revenue necessary to make a taxpayer indifferent between paying the 1%

⁵⁹ Uganda Revenue Authority, *Domestic Tax Laws*, 86.

⁶⁰ The personal income tax liability for a resident individual with chargeable income exceeding Shs. 4,920,000 is Shs. 546,000 plus 30% of the amount by which chargeable income exceeds Shs. 4,920,000.

small business turnover tax or the 30% corporate profits tax. This ratio is .967, meaning a taxpayer would be indifferent between paying the 1% turnover tax relative to the profits tax of 30% if costs are 96.7% of revenue (such a ratio can't be computed in respect to the personal income tax due to the multiple brackets that exist under the personal income tax).⁶¹ This means that any business with costs that are less than 96.7% of revenue would prefer to be taxed under the small business regime. Such a high ratio provides a strong incentive for standard tax regime taxpayers to reduce reported turnover in order to qualify for the small business regime.

Uganda's small business tax is also failing to meet the objectives of reduced compliance costs and increased revenue. The Enterprise Surveys data discussed previously indicates there are significant costs associated with starting and operating a business in Uganda. Further contributing to the cost of tax compliance is the time small businesses spend meeting with tax officials and complying with government regulations. Data provided by the URA indicates that small business tax revenue is miniscule and has been declining as a percent of total tax revenue over the last five years.

Recommendations for Reforming Uganda's Small Business Tax

I recommend Uganda amend their current small business tax regime and utilize net cash flow as the small business tax (SBT) base. Using net cash flow as the SBT base will reduce the distortions in the current turnover based regime and allow Uganda to maintain statutory record keeping requirements. Switching to a system with net cash flow as the base will not be a radical transformation for Uganda's taxpayers or the URA. Many small business taxpayers are already keeping books of account, likely on a cash basis. Furthermore, the Income Tax Act currently allows taxpayers to account on a cash or accrual basis, unless otherwise specified by the Commissioner General. I am proposing a number of other changes to correspond with the switch to a net cash flow based SBT.

Eligibility

The current eligibility requirements for the small business tax system are too inclusive. Currently, any resident taxpayer with less than fifty million shillings in gross turnover per year qualifies for the SBT regime provided they are not in the business of providing: "medical, dental, architectural, engineering, accounting, legal, or other professional services, public entertainment services, public utility services, or construction services."⁶³ These exclusions are not adequate and allow for potential tax evasion or avoidance amongst larger firms. Specifically, one large firm may split into a number of small smaller firms so that each separate business qualifies for the SBT.⁶⁴ Furthermore, the tax law does not include abuse of ownership rules. Such rules exclude certain small

⁶¹ Note that I make several assumptions in calculating cost to revenue ratio of 96.7%. I assume that 1% of turnover is the small business tax rate although the small business tax brackets allow the taxpayer to pay the lower of a fixed fee or 1% on turnover. I also used the 30% corporate profits tax rate in calculating the ratio, rather than individual income tax rates.

⁶³ Uganda Revenue Authority, *Domestic Tax Laws*, 19.

⁶⁴ Conrad and Alexeve, *Small Business Taxation*, 13.

businesses from the small business tax regime due to their ownership structure. An example of such a rule may be that no small business is allowed to have more than 25% direct corporate ownership.

Although the current upper threshold for the small business tax is equal to the threshold requirement for VAT, I recommend specific language be inserted into the tax law that permanently links the two thresholds. Accordingly, the definition of a small business should be:

“A small business is defined as any resident individual or qualifying entity with annual gross turnover less than or equal to the VAT threshold.”⁶⁵ Furthermore, the following taxpayers are excluded from the small business tax regime:

1. Any non-resident physical persons and permanent establishments of non-residents,
2. Any entity that has any economic interest,⁶⁶ direct or indirect, in another entity that is not a small business taxpayer,
3. Any entity whose equity is owned directly or indirectly by another entity or any nonresident person,
4. Any resident physical person or entity whose aggregate receipts from all economic activities exceed the VAT threshold,
5. Any state entity or any entity with state equity participation,
6. Any supplier of petroleum or gas products or any service to that sector (including service stations), any producer of other mineral resources or any service to the mineral sector,
7. Any resident individual or entity that is engaged in the production of excisable goods,
8. Any person electing to be subject to VAT,
9. Any entity with more than 5 shareholders, and
10. Any person engaged in, or having an economic interest in, financial services (including but not limited to banks, brokers and insurance companies).

⁶⁵ *ibid.*, 18.

⁶⁶ Economic interest in this context includes loans other than bank deposits and government securities. It makes little sense for a domestic resident to qualify for small business taxation while providing financing to entities that do not qualify for the small business tax.

11. Any person engaged in medical, dental, architectural, engineering, accounting, legal, or other professional services, public entertainment services, public utility services, or constructions services.

Forming a legal entity can be costly, and if a business has the wherewithal to form a legal entity it may not make sense for them to be a small business taxpayer. Under the rules I'm proposing some legal entities will meet the small business threshold but the anti-abuse rules I've included are designed to prevent legal entities that are capable of paying under the normal tax regime from entering the small business tax regime. Of particular importance is stipulation 4 which provides an aggregation test in order to prevent income splitting. Under the current small business tax regime, a taxpayer who is an employee with income taxes withheld from his wages may also operate a small business on the side, and that business may be eligible for the small business tax provided it meets the criteria. Under stipulation 4 above, that taxpayer's business will no longer be eligible for the small business tax regime provided the sum of his wages and business receipts exceed the VAT threshold. This stipulation is a simplification; whether a business is a VAT taxpayer or not says nothing about if they should pay personal income tax. The VAT threshold is only relevant if the entity is a trader business and gross turnover is above the VAT threshold.

Tax Base

Proponents of using turnover as the base argue that it is administratively simple. Turnover is already used to determine eligibility so no additional calculations are required to determine the base and taxpayers do not have to account for costs and tax administrators do not have to audit costs. Although it may be simpler to use turnover as the base relative to net cash flow, the incremental cost of accounting for costs are less than the benefits in my view. Some small businesses in Uganda already use cash flow accounting and others likely have the information required to do cash accounting, particularly if they have employees subject to wage withholding, maintain inventories, or purchase inputs from VAT taxpayers. For instance, a taxpayer that withholds taxes on employees' wages has the necessary information to reduce turnover by labor costs. Furthermore, if the business purchases inputs from a VAT taxpayer than a receipt must be issued thus allowing the business to account for input costs.

The primary benefit of using net cash flow as the base for the SBT is that it facilitates transition into the standard tax system. Small businesses will be forced to learn simple cash flow accounting and if these businesses grow to become large taxpayers it will be easier for them to adopt accrual accounting. Cash flow accounting will also help small businesses gain experience and perhaps gain access to formal capital markets. Finally, using net cash flow as the SBT base will result in a smaller marginal tax on a change to the standard tax regime – recall how it is currently 1,900%. Reducing this marginal tax will reduce the incentive firms have to remain in the small business tax system.

As businesses move from the small business tax regime into the standard regime and switch from cash to accrual accounting the URA must determine how the balance sheet

will be adjusted to the change. Assume a business is currently in the small business tax regime and will transfer to the standard tax regime beginning January 1, 2012. If this business takes out a loan this year (2011), should they be allowed to deduct interest on this loan in 2012? To simplify matters, I recommend that for tax purposes the URA disregard any tax balance sheet at the beginning of the transition and all assets placed in service after the transition date will use standard depreciation and, accordingly, a tax balance sheet developed from the transition date forward.⁶⁷ I also recommend that interest on pre-existing debt be deductible after the transition. Allowing pre-existing debt to be deductible after the transition does create an incentive for taxpayers who anticipate moving out the small business tax regime to leverage prior to the transition so they can expense all asset purchases and then get the interest deduction upon transitioning into the standard regime. This incentive is a onetime event and is more appealing from a tax administration standpoint than the alternative of not allowing the interest deduction on pre-existing debt which creates an incentive for taxpayers to refinance after the transition. I propose that any pre-paid expenses purchased prior to the transition cannot be deducted after the transition and that sales and costs begin to accrue on the date of the transition. Accounts receivable and accounts payable before the transition should be ignored after the transition occurs. The transition and reporting in general will be facilitated if there is a simple reconciliation computation which demonstrates the difference between tax and financial balance sheets modeled on the US system (See US 1120 tax return for an example).

The current definition of cash accounting, Section 41 of the Income Tax Act, is too vague and open for abuse: “A taxpayer who is accounting for tax purposes on cash basis derives income when it is received or made available and incurs expenditure when it is paid.”⁶⁸ I recommend this section be amended so that cash flow is defined as: “The difference between cash receipts and cash expenses.” The Income Tax Act will also have to define cash receipts and cash expenses. I recommend the following definitions:

Cash Receipts: The value, either in cash or in-kind, received for any good or service supplied by the business, including the disposal of any capital asset (tangible or intangible) attributable to business without regard to source. Cash receipts also include payments, either in cash or in-kind⁶⁹, from all types of capital, including interest, dividends and royalties as well as all proceeds from loans attributable to the business except any payment received from owners in exchange for a specified good or service. Payment received from owners that are not included in cash receipts include capital contributions, loan repayments and interest receipts.⁷⁰

Cash Expenses: The value, either in cash or in-kind, paid in exchange for the purchase of any good or service including the purchase of any capital asset (tangible or intangible) attributable to the business without regard to source. Cash expenses also include payments, either in cash or in-kind, for all types of capital expenses including interest,

⁶⁷ The URA may have to worry about the interaction between the allowable interest expense and any thin capitalization rule that may exist in Uganda.

⁶⁸ Uganda Revenue Authority, *Domestic Tax Laws*, 46.

⁶⁹ Bartering transactions should be treated as equivalent to cash transactions.

⁷⁰ Robert Conrad, "Calculation of Cash Flow for Small Business Taxation" (Memo,)1.

principal, and royalties except any payments to the equity owners in exchange for a specified good or service. Payments to owners that are not included in cash expenses include, but are not limited to: dividends (or payments that are constructive dividends), interest payments, principal repayments, a loan to the owner and repayments of capital contribution to the owner of equity capital.⁷¹

The above definitions consider loan proceeds as cash in and principal and interest payments as cash out. An alternative method is to not include loan proceeds as cash in and not include principal and interest payments as cash out. I recommend the former but the URA should adopt the method that is most transparent and administratively simple.

Another benefit of using cash flow as the base is that the marginal effective tax rate is zero. Consider a simple example of a small business that has cash receipts of 40,000,000 shillings and cash expenses of 30,000,000 shillings. This businesses net cash flow is 10,000,000 and if the tax rate is 30% the business will pay taxes of 3,000,000 shillings. In this scenario, the effective tax rate, measured as the proportion of tax payable to inclusive profit, is 30% (3,000,000 tax payable divided by 10,000,000 inclusive profit. Now consider what happens to the effective tax rate if the businesses profit increases by one shilling. So now, the business has cash receipts of 40,000,001 shillings and still has cash expenditures of 30,000,000 shillings. The net cash flow is 10,000,001 and the tax payable is 3,000,000.30. Under the new scenario, the effective tax rate is still 30% (3,000,000.30/10,000,001). Thus, the marginal effective tax rate from any increase in profit is zero. See appendix 4 for more detailed examples of calculating net cash flow and appendix 5 for an example of a small business tax form based on net cash flow.

Tax Rate

Determining the proper tax rate under the net cash flow system is difficult due to the two distinct classes of taxpayers within the small business tax regime – physical persons and corporations. Physical persons in the small business tax (SBT) regime can be divided into two subgroups: physical persons whose sole source of income comes from operating an unincorporated business and physical persons with business income and income from other sources, like wages. In the absence of the small business tax regime both physical person subgroups would be taxed under the personal income tax (PIT) and all corporations would be taxed according to the corporate income tax (CIT).

I propose that the small business tax rate be set equal to the top marginal rate under the personal income tax and corporate income tax – 30%. Physical persons with taxable income below the threshold for the top marginal rate of 30% would prefer to be taxed under the PIT because their tax liability would be lower than under the SBT regime. To account for this preference taxpayers can elect not to be taxed under the SBT regime and choose to be assessed according to the applicable tax, either PIT or CIT. This means that physical persons with business income and wage earnings can either have their wage earnings assessed under the PIT and their small business income assessed under the SBT – provided the eligibility requirements are met – or they can choose to have their wage

⁷¹ *ibid.*, 1

earnings and small business income aggregated and assessed under the PIT. Note that the aggregation test described previously only determines eligibility for the SBT regime; it does not determine the tax base. Corporations that qualify for the SBT regime may also elect to be assessed under the CIT. Any taxpayer that qualifies for the SBT regime but elects to be assessed under the PIT or CIT may not return to the SBT regime for a period no less than three years.

Tax Credits

The existing tax credits for withholding tax paid in respect of amounts included in the gross turnover of the taxpayer shall be maintained.

Provisional Tax

Small business taxpayers whose income is not subject to withholding at source will still be required to pay provisional tax. The installment schedule will remain intact, with individual provisional taxpayers required to pay four installments per year and all other provisional taxpayers paying two installments per year. Under the new regime, small business provisional taxpayers will estimate their tax liability based on net cash flow. A small businesses provisional tax payment will be calculated accordingly:

1. Compute cumulative taxable cash flow for that semi-annual period.
2. Compute the tax due before credits if cumulative cash flow is greater than zero.
3. Compute semi-annual taxes payable by subtracting semi-annual tax payments made for previous quarters in the same tax period and other credits allowed under the small business tax.

By switching to a net cash flow based small business tax, small business provisional taxpayers are no longer required to furnish estimates of gross turnover for each year of income nor will they be required to furnish estimates of net cash flow for each year of income.

In Lieu of Taxation

Section 4, subsection 5, part a, of the Income Tax Act states that the small business tax “shall be a final tax on the business income of the taxpayer.”⁷² This language should be amended to read: The small business tax will be paid in lieu of personal income tax or corporate income tax as the case may be. This definition does create incentives for physical persons under the small business tax regime to claim personal expenses as business expenses in order to reduce their tax liability. To deal with this issue I recommend the URA introduce personal expense limitations into their audit selection criteria.

⁷² Uganda Revenue Authority, *Domestic Tax Laws*, 19.

Employee

Small business tax regimes provide an incentive for employees to become contractors. The current definition of employee in the Income Tax Act is inadequate: “‘employee’ means an individual engaged in employment.”⁷³ To prevent abuse I recommend a definition of employee be included in the Income Tax Act based on the United States’ IRS language:

Employee- a physical person performing work for another person or entity for remuneration, either in money or in kind, where the payer has the right to control or direct both the result of the work and the manner in which these results will be obtained.

See appendix 6 for a useful table designed to assist the URA in determining employee status.

Other Matters

For the purposes of the small business tax regime, spouses and children will be treated as one individual.

Transition Rules

As discussed previously, it is difficult to design a mechanism that graduates taxpayers out of the small business tax regime and into the standard tax regime. Transition mechanisms require a tradeoff between relatively quick and simple and gradual and complex. A quick and simple option would be to tax taxpayers during their first year in the standard tax regime at 50% of their prior tax liability and 50% of their liability under the standard regime. A gradual and complex option would be to utilize weighted averages over a five year horizon. For instance, in the taxpayers first year under the standard regime their tax liability would be 80% of their prior period’s tax liability and 20% of their liability under the standard regime. In their second year under the standard regime, their tax liability would be 60% of their tax liability in their last year in the small business tax regime and 40% of their liability for the current year under the standard regime. The third through fifth years would follow the same pattern.

I recommend two actions previously proposed by Bob Conrad and Mike Alexeve to ease the transition.

1. A taxpayer who becomes eligible for a different taxation regime will change the regime only at the beginning of the next tax year.
2. At the taxpayer’s option, the tax liability during the first year under a new status will be equal to 50% of the total liability computed by reference to the taxpayer’s prior status and 50% of the total liability computed by the reference to the

⁷³ *ibid.*, 11

taxpayer's new status. For instance, suppose the taxpayer qualified for the small business tax regime in Year 1 and the standard tax regime in year 2. If the tax liability under the small business regime was Shs. 1,000,000 and under the standard regime it was Shs. 2,000,000, then tax liability during the transition year would be Shs. 1,500,000 if the taxpayer chooses the election.

Audit Rules

A small business tax will require different audit procedures than the standard tax regime because the method of accounting is different. I recommend the URA adopt specific selection criteria for auditing small businesses.

Taxpayer Services

The URA has taken great strides to engage the public and educate taxpayers about their responsibilities. However, more work needs to be done regarding taxpayer education, particularly in the small business sector. This includes training URA staff in simplified accounting procedures who can then train the small business community. The URA should also consider distributing simplified books along with instructions on how to keep proper records to small businesses, free of charge. Lastly, I recommend the URA utilize television and radio advertising to explain tax laws and encourage voluntary compliance. Developing an effective marketing strategy for the URA is beyond the scope of this project but it's clear the URA can do more to increase tax compliance by way of taxpayer education.

Appendix 1: Results from World Bank Enterprise Surveys

Regulations And Tax	Uganda	Small	Medium	Large
Senior Management Time Spent in Dealing with Requirements of Government Regulation (%)	5.21	5.3	5.15	4.52
Average number of visits or required meetings with tax officials.	2.4	2.27	2.62	2.83
If there were visits, Average number of visits or required meetings with tax officials.	2.83	2.74	3	3.01
% of Firms Identifying Tax Rates as Major Constraint***	62.65	67.66	56.43	36.31
% of Firms Identifying Tax Administration as Major Constraint***	23.58	24.93	20.67	22.04
Corruption	Uganda	Small	Medium	Large
% of Firms Expected to Pay Informal Payment to Public Officials (to Get Things Done)	51.7	50.32	56.46	44.34
% of Firms Expected to Give Gifts In Meetings With Tax Officials	14.53	13.93	15.01	18.31
% of Firms Expected to Give Gifts to Secure a Government Contract**	45.46	42.07	54.89	38.39
Informality	Uganda	Small	Medium	Large
% of Firms expressing that a Typical Firm Reports less than 100% of Sales for Tax Purposes	74.49	78.97	68.63	50.31
% of Services Firms Competing Against Unregistered or Informal Firms	73.11	73.21	71.36	n/a
% of Firms Identifying Practices of Competitors in the Informal Sector as a Major Constraint***	35.3	37.41	31.25	30.74
Finance	Uganda	Small	Medium	Large
% of Firms with Line of Credit or Loans from Financial Institutions	17.22	15.42	14.47	49.22
% of Firms With a Checking or Savings Account	85.77	81.89	92.48	97.24
% of Firms Using Banks to Finance Investments	7.67	5.24	7.86	33.21
Internal Finance for Investment (%)	78.3	81.94	77.96	55.64
Bank Finance for Investment (%)	12.75	9.81	11.99	34.89
Sales Sold on Credit (%)	17.52	13.53	22.38	38.91
% of Firms Identifying Access to Finance as a Major Constraint***	47.81	48.03	48.51	42.33
Innovation and Technology	Uganda	Small	Medium	Large
% of Firms with Annual Financial Statement Reviewed by External Auditor	50.66	37.43	71.47	100
Workforce	Uganda	Small	Medium	Large
Average Number of Seasonal/Temporary, Full-Time Employees	5.64	1.93	8.38	38.56
Average Number of Permanent, Full Time Employees	21.14	8.84	34.82	118.5

Source: World Bank Enterprise Surveys, 2006

Appendix 2: Comparison of Small Business Tax Regimes in Latin America & Africa

In 2007, the organization International Tax Dialogue (IDP) held a conference on taxation of small and medium enterprises. The background paper for the conference included a summary table of special SME tax regimes in Latin America and Sub-Sahara Africa; a copy of the table is included below. The table does not include country specific details of special tax regimes but it does provide a useful comparison of how countries in Latin America and Sub-Sahara Africa structure special tax regimes.

Special tax regimes are widely used in both regions, with 14 out of 17 countries in Latin America and 25 out of 44 countries in Sub-Sahara Africa employing some kind of simplified regime for small businesses. In Sub-Sahara Africa, turnover is the primary qualification criteria for the special regime and the turnover threshold is often explicitly linked to the VAT threshold. In Latin America, some countries rely on turnover as the qualification criteria but others utilize measures such as the number of employees, electricity bill, physical area, or number of vehicles. Sub-Saharan African countries typically apply only one tax regime to small businesses whereas some Latin American countries have two or more presumptive regimes that are generally tailored to businesses of different sizes or sectors. In Sub-Sahara Africa small business taxes generally apply to unincorporated business only but in Latin America the type of entities covered range from individuals to incorporated businesses. Tax liability for special tax regimes in Sub-Sahara Africa can be computed several ways. The most common methods are a fixed amount across turnover bands or a percentage of turnover. Uganda relies on a hybrid of the two, assessing the taxpayer at the lower of the fixed amount that varies within turnover bands or a percentage of turnover. In Latin America, percentage of turnover or a fixed fee is the most frequent methods of computing tax liability. Finally, special tax regimes in Sub-Sahara Africa typically replace all other taxes but in Latin America there is far more variability across countries as to the taxes that the special tax regime replaces.

	Latin America	Sub-Saharan Africa
Extent of presumptive regimes in the region	Latin American countries have adopted a wide range of simplified regimes for SMEs. Of 17 countries, 14 have adopted some type of simplified taxation (Argentina, Bolivia, Brazil, Colombia, Costa Rica, Chile, Dominican Republic, Ecuador, Mexico, Nicaragua, Honduras, Paraguay, Peru, and Uruguay). Exceptions are El Salvador, Panama and Venezuela.	Pervasive: 25 out of 44 countries in the region for which data are available have special regimes for smaller enterprises (Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, Republic of Congo, Côte d'Ivoire, Gabon, Guinea, Kenya, Liberia, Mali, Mauritania, Niger, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, Uganda, and Zambia). Almost half apply (usually creditable) withholding income tax on imports.
Criteria for qualification	Some countries use turnover as the principal criterion for qualification (Brazil, Chile, Dominican Republic); others use objective parameters as the primary criteria, such as physical area, electricity bill, number of employees, or number of vehicles as the main qualification, or use these as additional criteria (Argentina, Bolivia, Colombia, Costa Rica, Chile, El Salvador, Honduras, Mexico, Nicaragua, Paraguay, Peru and Uruguay); some countries prohibit certain economic sectors from presumptive taxation (e.g., Brazil).	Turnover is almost universally used as a qualification criteria, with the special regime generally linked explicitly to the VAT threshold.
Existence of multiple regimes	Some countries have two or more presumptive regimes (Argentina, Bolivia, Brazil, Chile,	Generally a single regime, though in some cases (Liberia and Uganda) with

	Latin America	Sub-Saharan Africa
	Mexico, Peru and Uruguay). These multiple regimes are used to tailor solutions for businesses of different sizes or specific economic sectors, such as agriculture, handicrafts, and transport.	structurally different treatment of the smallest taxpayers.
Universe of taxpayers covered	Some countries provide presumptive regimes for individuals, usually self-employed or unincorporated businesses (Argentina, Bolivia, Colombia, Chile, Dominican Rep., Ecuador, Mexico, Nicaragua, Honduras, Paraguay, Peru and Uruguay), while others also provide this for legal entities or incorporated businesses (Brazil, Costa Rica, Chile, Mexico, Peru and Uruguay).	Typically for unincorporated enterprises only, though in a few cases (such as Zambia) it applies to corporations too.
Tax calculation	The main tax calculation methods are percentage of the turnover level (Brazil, Chile, Dominican Rep., Peru) and/or a patent or fixed quota (Argentina, Bolivia, Chile, Mexico, Nicaragua, Peru and Uruguay).	Most common methods are: fixed amounts varying across turnover bands (examples being mainly in Francophone countries such as Burkina Faso and Togo); percentage of turnover, either uniform or at multiple rates (such as in Rwanda and Tanzania respectively); fixed amounts varying across turnover bands (examples being Burkina Faso and Togo); and forfait/standard assessment methods (in Burundi and Gabon, for instance).
Type of revenue covered (applied in lieu of taxes and/or social security contributions)	Many regimes substitute for only one tax (Brazil, Colombia, Chile, Dominican Rep., Ecuador, Honduras, Paraguay, Peru) but others--even in the same countries-- include more than one tax, usually the income tax and the VAT (Argentina, Brazil, Bolivia, Costa Rica, Mexico, Nicaragua, Paraguay, Peru and Uruguay). In the case of Brazil, sub-national taxes are also included. Some presumptive regimes also substitute for social security contributions (Argentina, Brazil and Uruguay).	The presumptive schemes generally replace all other taxes.
Turnover threshold	A wide range: some countries define it at a low level to cover mainly micro and very small (usually unincorporated) businesses (below US\$ 50,000); Brazil is an exception with a threshold at US\$ 1,000,000 (in lieu of all taxes and social contribution) and US\$ 20,000,000 (in lieu of income tax only).	Commonly linked to the VAT threshold, which varies from around 12,000 USD to around 100,000 USD, but is commonly in the range 40-80,000 in Francophone countries and 30-40,000 USD in Anglophone countries.

Source: Inter-American Development Bank (2007) and IMF staff

Appendix 3: Small Business Tax Regimes Around the World

Country	Criteria to Qualify	Tax Base	Tax Rates
Azerbaijan	Businesses with turnover less than 300 times the maximum tax-exempt wage	Gross Turnover	2% of gross turnover
Belarus	Stores that are single owned and total trading space less than 25 square meters, plus public catering enterprises, and at markets and sales exhibitions.		Lump Sum
Benin	Enterprises under the presumptive system are subject to that system based on their turnover or the nature of their business. The threshold for application of the presumptive system is CFAF 40 million for businesses and CFAF 15 million for service providers.	The Simplified Tax System (RSI) applies to all types of taxpayers, individuals or corporations, whose annual turnover meets the established threshold.	There are differences in the tax treatment of small businesses. In towns that have a special status, small enterprises are subject to a composite tax, the single professional tax (TPU), and are not required to declare. Their tax is calculated using an automatic formula based on data collected by tax officers during the annual tax surveys. Small businesses in other localities are subject to the presumptive BIC, whose base is the result of an understanding with the taxpayer and is renewable by tacit rollover to the next year. A reform is under way to harmonize treatment in the case of small enterprises.
Brazil	There are two different presumptive systems in Brazil. Both systems are for juridical entities. The SIMPLES is for business with turnover level below R\$ 2,400,000 (however, some restrictions apply for particular economic sectors that cannot opt for this system). The "Lucro Presumido" is for companies with turnover level below R\$ 48,000,000 (and there are also restrictions for specific economic sectors). Therefore, the criteria involves a mix of turnover level and economic activity.	The tax base for both the SIMPLES and the "Lucro Presumido" is the annual turnover.	Rates vary only in function of the turnover level.
Ethiopia	Annual turnover less than USD 5,000	Annual Turnover	Varies by 69 different professions and 19 turnover bands
Ghana	Vehicle Income Tax (VIT) require transport owners and drivers to pay income tax on a quarterly basis through a sticker system	Type of vehicle	Taxis and cars on hire and trotros (passenger vans) of up to 19 passengers are required to pay a quarterly amount of 48,000 cedi; trotros of between 20 and 34 seats pay 72,000 cedis, with those from 35 seats and above have to pay 96,000 cedis.
Hungary	Only private entrepreneurs and business entities that have been in business for at least two years, have an annual income (including VAT) not exceeding 25 million HUF (approx. US\$120,000), and where all of the business owners are individuals can opt for this form of taxation	Sales Revenues	25%

Appendix 4: Examples of Computing Net Cash Flow

- (1) Unless stated otherwise, all transactions described in the examples below occur during a single tax period;
- (2) “Wages” include all expenditure on labor including wages, payroll taxes, and benefits except those of the owner or the owner’s immediate family;
- (3) Expenditures on inputs that are taxable by VAT and excises include VAT and excises.
- (4) Notation: CR – cash receipts; CE – cash expenses; CF – cash flow.

Examples

1. A business sells 5,000 shirts at 8,000 shillings per shirt. During the same period, the business spends 20,000,000 shillings on fabric and other material inputs such as electricity and dyes. In addition, the business pays 10,000,000 shillings in wages. The business also replaces its old sewing machines with new ones. The old machines are sold to an unrelated business for 3,000,000 shillings and the new machines are purchased for 10,500,000 shillings.

$$CR = 5,000 * 8,000 + 3,000,000 = 43,000,000 \text{ [turnover + sale of capital assets]}$$

$$CE = 20,000,000 + 10,000,000 + 10,500,000 = 40,500,000 \text{ [material inputs + wages + purchase of capital assets]}$$

$$CF = 43,000,000 - 40,500,000 = 2,500,000$$

2. Same as (1) above, but one of the 100 shirts is given to the owner’s son.

The above answers do not change.

3. A restaurant receives 38,000,000 shillings in revenues from food sales to its patrons. It spends 24,000,000 shillings on non-labor inputs such as food, electricity, and rent of the premises. Also, it spends 10,200,000 shillings on wages. In addition, the restaurant sells a recipe to a restaurant in another town for 8,000,000 shillings.

$$CR = 38,000,000 + 8,000,000 = 46,000,000 \text{ [turnover + sale of intangible asset]}$$

$$CE = 24,000,000 + 10,200,000 = 34,200,000$$

$$CF = 46,000,000 - 34,200,000 = 11,800,000$$

4. Two physical persons, A and B, own a flower shop as a simple partnership. The shop sells 40,000,000 shillings of flowers and related services. It spends 28,000,000 shillings

on non-labor inputs and 16,000,000 shillings on wages. Person B contributes his car worth 8,000,000 shillings to the shop and lends it 4,000,000 shillings in cash to augment the shop's working capital. (The contribution of the car will lead to an increase in B's share of ownership of the shop.) In addition, the shop borrows 9,000,000 shillings from a bank. The shop makes interest payments of 1,200,000 shillings to the bank and 400,000 shillings to person B and repays 2,000,000 shillings of principal to the bank and 400,000 shillings of principal to person B.

$$CR = 40,000,000 + 9,000,000 = 49,000,000$$

$$CE = 28,000,000 + 16,000,000 + 1,200,000 + 2,000,000 = 47,200,000 \text{ [non-labor inputs + labor + interest payment to the bank + principal repayment to the bank]}$$

$$CF = 49,000,000 - 47,200,000 = 1,800,000$$

Note that neither the value of the car (8,000,000 shillings) nor the 4,000,000 shilling cash loan by person B are included in cash receipts. Similarly, neither interest paid to B nor repayment of principal to B are included in cash expenses.

5. A business sells and leases computer equipment. It sold 40,000,000 shillings worth of equipment for immediate cash payment. Also, it leased 16,000,000 shillings worth of computers to customer A, who made 4,000,000 shillings in lease payments during the tax period. The lease agreement stipulates that customer A has the option to buy the leased equipment outright at the end of the lease in the following tax period for 14,400,000 shillings. The business's cash expenses for the period amounted to 30,000,000 shillings.

$$CR = 40,000,000 + 4,000,000 = 44,000,000$$

$$CE = 30,000,000$$

$$CF = 44,000,000 - 30,000,000 = 14,000,000$$

Note that the fact that customer A might be buying the leased equipment in the future does not affect cash flow in the current tax period.

6. A business sells and rents out furniture. It sold 15,000,000 shillings worth of furniture to customer A, who paid cash. Customer B rented furniture and paid 800,000 shillings in rental payments during the tax period. Customer C purchased 20,000,000 shillings worth of furniture, but he did not pay cash. Instead, the business and customer C agreed that C would take possession of the furniture and owe the business 20,000,000 shillings. That is, in effect, customer C borrowed 20,000,000 shillings from the business to pay for the furniture. During the tax period, customer C paid the business 4,000,000 in interest and 6,000,000 in principal repayment. In addition, customer C paid 200,000 shillings as a penalty for being late with one of his payments. The business's non-labor inputs and wages during the period amounted to 28,000,000 shillings.

$CR = 15,000,000 + 800,000 + 20,000,000 + 4,000,000 + 6,000,000 + 200,000 = 46,000,000$
[cash sales of furniture + rental payments + sale of furniture on installments + interest received + principal repayment received + penalty charge received]

$CE = 28,000,000 + 20,000,000 = 48,000,000$ [non-labor inputs and wages + loan advanced]

$CF = 46,000,000 - 48,000,000 = -2,000,000$

7. A taxicab business borrows 20,000,000 shillings from a bank and uses the entire loan to purchase an additional car. The payment of interest and principal during the tax period is 4,000,000 shillings. The business's revenues from taxicab services are 29,000,000 shillings. The business's costs of operating the cabs, including non-labor inputs and wages are 16,000,000 shillings.

$CR = 20,000,000 + 29,000,000 = 49,000,000$ [loan obtained + revenue from taxicab services]

$CE = 20,000,000 + 4,000,000 + 16,000,000 = 40,000,000$ [capital asset purchase + payment of interest and principal + non-labor inputs and wages]

$CF = 49,000,000 - 40,000,000 = 9,000,000$

8. Same as (7), but the loan is from the business's owner and not from the bank.

$CR = 29,000,000$

$CE = 20,000,000 + 16,000,000 = 36,000,000$

$CF = 29,000,000 - 36,000,000 = -7,000,000$

Note that capital transactions with owner of the business do not affect cash flow calculations.

9. A publishing business prints and sells a book by author A. Sales proceeds are 45,000,000 shillings. The costs of printing and selling the book incurred in this tax period are 36,000,000 shillings. The business pays author A royalty equal to 10% of sales.

$CR = 45,000,000$ [sales proceeds]

$CE = 36,000,000 + 0.1 * 45,000,000 = 40,500,000$ [selling and printing costs + royalty]

$CF = 45,000,000 - 40,500,000 = 4,500,000$

10. Same as (9) above, but in addition, the author is paid an advance of 20,000,000 shillings against his future royalties.

$$CR = 45,000,000$$

$$CE = 36,000,000 + 20,000,000 = 56,000,000$$

$$CF = 45,000,000 - 56,000,000 = -11,000,000$$

11. Same as (9) above, but author A is an owner of the publishing business. Royalty payment does not enter into cash flow calculations, because royalty payment to the owner is a capital transaction with the owner:

$$CR = 45,000,000$$

$$CE = 36,000,000$$

$$CF = 45,000,000 - 36,000,000 = 9,000,000$$

12. A car repair shop receives 44,000,000 shillings for its services. Also, it keeps part of its assets in dividend-paying securities and receives 2,000,000 shillings in dividends. The shop's costs of running the business (wages and other inputs, including wages of the owner, who is a car mechanic) are 34,000,000 shillings.

$$CR = 44,000,000 + 2,000,000 = 46,000,000$$

$$CE = 34,000,000$$

$$CF = 46,000,000 - 34,000,000 = 12,000,000$$

13. A car rental business earns 29,000,000 shillings in car rentals. In addition, it collects 10,000,000 shillings in insurance premiums and 5,000,000 shillings in payments from customers for uninsured damages to the rented cars. Of these 5,000,000 shillings, 2,000,000 shillings was paid for an uninsured car that was totaled. The business spends 30,000,000 shillings on car repair and maintenance and on general administration. Also, it paid 11,000,000 shillings in insurance premiums to the insurance company. Some of the insured cars were damaged and the insurance company paid the business 3,000,000 shillings for these damages. Finally, the business spends 12,000,000 shillings to replace the totaled car.

$$CR = 29,000,000 + 10,000,000 + 5,000,000 + 3,000,000 = 47,000,000 \text{ [rental income + insurance premiums + payments for damages from uninsured customers + payments by insurance company]}$$

$CE = 30,000,000 + 11,000,000 + 12,000,000 = 53,000,000$ [repair and maintenance expenses + insurance premiums + purchase of the car]

$CF = 47,000,000 - 53,000,000 = 25,000,000$

14. Same as in (14) above, but the 3,000,000 shillings payment for the totaled car was not received in the current tax period.

$CR = 29,000,000 + 10,000,000 + 3,000,000 + 3,000,000 = 44,000,000$

$CE = 53,000,000$

$CF = 44,000,000 - 53,000,000 = -9,000,000$

15. A shop, organized as a small business entity, sells goods worth 40,000,000 shillings and has expenses of 18,000,000. In addition, the shop sells used equipment for 4,000,000 and prepays expenses for the next tax year for 6,000,000.

$CR = 40,000,000 + 4,000,000 = 44,000,000$

$CE = 18,000,000 + 6,000,000 = 24,000,000$

$CF = 44,000,000 - 24,000,000 = 20,000,000$

16. A safari operator, organized as a small business entity, provides services and receives billings in cash of 44,000,000. The law firm holds some equity securities as part of working capital. The firm sells some of these securities this year for 800,000. Cash expenses are equal to 40,000,000

$CR = 44,000,000 + 800,000 = 44,800,000$

$CE = 40,000,000$

$CF = 4,800,000$

Appendix 5: Example of Small Business Tax Form Based on Net Cash Flow⁷⁴

Name			
Address			
Business Type		Industry Number	
Value of Turnover			

Part I: Net Cash Flow

	GROSS RECEIPTS	
1	Value of Turnover	
2	Taxable Interest Income	
3	Value of Asset Disposals	
	Other Gross Receipts	
4	Total Gross Receipts (Summation of lines 1 – 3)	
	CASH EXPENSES	
5	Wages and Other Employee Compensation	
6	Purchased Inputs	
7	Purchased Services	
8	Purchased Inventories	
9	Purchased Capital Goods	
10	Total Expenses (Summation of lines 5 – 9)	

⁷⁴ Note this is an example only. The form should be developed by a form designer with input from legal experts to ensure proper signatures and certifications

Appendix 6: Guidelines for Determining Employee Status

The URA can use the following table that the United States' IRS uses to determine employee or contractor status. When the results of the table's criteria are split evenly between employee status and contractor status, the individual should be considered an employee.

<i>Employee or Independent Contractor</i>	
Employee	Independent Contractor
1. Instructions	
Employees comply with instructions about when, where, and how work is to be performed.	Contractors set their own hours and do the job in their own way.
2. Training	
Employees are trained to perform services in a particular way. They are required to take correspondence courses and attend meetings. Other methods also indicate that the employer wants the services performed in a particular way.	Contractors use their own methods and receive no training from the purchaser of their services.
3. Integration	
Services of an employee are merged into the business. Success and continuation of the business depends upon these services. The employer coordinates work with that of others.	The success and continuation of the business aren't dependent on services provided by a contractor.
4. Services Rendered Personally	
Services must be rendered personally. An employee does not engage other people to do the work.	Contractors are able to assign their own workers to do the job.
5. Hiring, Supervising, Paying	
An employee hires, supervises and pays workers at the direction of the employer (i.e.: acts as foreman or representative of the employer).	Contractors hire, supervise and pay the other workers as the result of a contract. A contractor agrees to provide materials and labor and is responsible for the results.

6. Continuing Relationship	
An employee continues to work for the same person year after year.	Contractors are hired to do one job. There is no continuous relationship.
7. Set Hours of Work	
An employee's hours and days are set by the employer.	Contractors are masters of their own time.
8. Full Time Required	
An employee normally works full time for an employer.	Contractors are free to work when and for whom they choose.
9. Doing Work on Employer's Premises	
Employees work on the premises of an employer; or on a route, or at a site, designated by the employer.	Contractors work off an employer's premises and use their own offices, desks, and telephones.
10. Order or Sequence Set	
An employee performs services in the order or sequence set by the employer. Salespersons report to the office at specified times, follow-up on leads, and perform certain tasks at certain times.	Services are performed at a contractors own pace. Salespersons work their own schedules and usually have their own offices.
11. Oral or Written Reports	
Employees are required to submit regular oral or written reports to the employer.	Contractors submit no reports.
12. Payment by Hour, Week, Month	
Employees are paid by the employer in regular amounts at stated intervals.	A contractor is paid by the job on a straight commission.
13. Payment of Business and/or Travel Expenses	
The employer pays employees' business	Contractors take care of their own expenses

and/or travel expenses.	and are accountable only to themselves for expenses.
14. Furnishing of Tools, Materials	
An employer furnishes tools, materials, etc.	Contractors furnish their own tools, etc.
15. Significant Investment	
An employee has no significant investment in the facilities used to perform services.	A contractor has a real, essential and significant investment.
16. Realization of Profit or Loss	
An employee cannot realize a profit or loss by making good or bad decisions.	Contractors can realize a profit or suffer a loss as a result of their services or decisions.
17. Working for More than One Firm at a Time	
An employee usually works for one employer at a time.	An independent contractor works for a number of persons or firms at the same time.
18. Making Services Available to the General Public	
An employee does not make services available to the general public.	Contractors have their own offices and assistants. They hold business licenses, are listed in business directories, maintain business telephones, and otherwise generally make their services available to the public.
19. Right to Fire	
An employee can be discharged at any time.	Contractors cannot be fired so long as product results meet contract specifications.
20. Right to Quit	
Employees can quit their jobs at any time without incurring liability.	Contractors agree to complete a specific job and are responsible for satisfactory completion; or they are legally obligated to make good for any failure.

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